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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 this point, the **main drivers of financial markets** are solid but below-trend global real GDP growth, with the usual wide disparity between developed and emerging economies, low rates of capacity utilization and very expansionary monetary policies in OECD countries in an environment of distressed labor markets, falling inflation rates and a focus of fiscal policies on budget consolidation, not stimulus.

2. **Financial repression for the benefit of debtors and at the expense of savers will continue**: government debts and deficits are considered to be unsustainable; debt reduction and balance sheet repair, or deleveraging, is also under way in most of the financial industry and the household sectors in countries where real estate bubbles have popped. Policy rates in rich countries are therefore close to zero and expected to remain unchanged for a considerable time. Households and institutional investors are once again desperately looking for assets with positive real yields.

3. **Equities with high dividends and corporate bonds will thus do well. Growth stocks and commodities are out of favor.**

4. **Three large risks investors had been worrying about have recently disappeared from their radar screens: that the euro would crash, that tax increases and automatic spending cuts ("sequestration") could cause a new recession in the US, and that China's growth rate would continue to decline.**

5. **A new risk is the fall-out from the Fed's announcement** last week that the massive bond buying program will be phased out by the middle of 2014, incoming data permitting. According to Mr. Bernanke, US growth has finally gained so much momentum that this kind of policy support can gradually be withdrawn. Investors fear that the approaching end of unlimited dollar liquidity heralds the end of the 30-year bond rally, not only in the US but in developed markets in general. For this to happen, inflation expectations and unit labor costs would have to rise, accompanied by higher policy rates. None of this is likely. It means that **the recent weakness of bond and equity markets is temporary.** It has created new buying opportunities. Commodity prices are no "buy" yet – they are on a longer-lasting downtrend. Emerging economies and their currencies will continue to be negatively affected by the approaching end of dollar printing.

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more signs that the euro will survive

6. To begin with the first risk, market participants are upbeat about the future of the euro: it has been **appreciating against dollar, yen, the renminbi and the currencies of commodity producers such as the rouble or the Canadian and Australian dollars.** Another sign of trust in the euro has been the dramatic narrowing of yield spreads between "safe" German government bonds and those of crisis countries in the periphery of the currency union: in the past twelve months, yields of 10-year bonds have increased from 1.5 % to 1.7% in Germany, while they have come down from 25.8% to just 10.9% in Greece, from 9.9% to 6.3% in Portugal, from 6.6% to 4.9% in Spain, and from 5.7% to 4.6% in Italy. Irish yields have fallen to just 4.0%.

7. It shows that **the austerity policies and structural reforms** that are implemented in the countries hit most severely by the financial crisis are **considered to be credible**. Social strains will probably not derail the adjustment process. But it is not only that: euro area yields have also been brought down by a general global lack of attractive high-yield alternatives.

8. **Another important factor that helped has been the ECB.** Last July, Mr Draghi stated that the central bank would do whatever it takes to stabilize the euro. In September, he followed up with the announcement that the ECB is prepared to do outright monetary transactions (OMTs): it would buy, without a formal limit, bonds of those countries which had agreed to meet the conditions of the euro area rescue mechanisms EFSF/EMS. These conditions require a reduction of government budget deficits and the implementation of structural reforms aimed at improving competitiveness.

9. The threat was, and is, so powerful that the ECB did not need to buy a single bond under OMT so far. Market participants are now resigned to the insight that **it is futile to speculate against the ECB.** Financial investors who had bet on shrinking intra-euro area yield spreads, believing what Mario Draghi had said, have made a killing over the past year.

the euro's sound fundamentals

10. **From a purely economic, as opposed to a political perspective, the euro is a rather sound currency.** The numbers are better than suggested by its bad reputation in the international financial press. According to the latest Economic Outlook of the OECD (May 29), the consolidated current account surplus of the 17 member countries will be 2.5 per cent of GDP in 2013, compared to a deficit of 3.1 per cent in the US. In absolute and relative terms, the surplus is expected to be even bigger than China's (2.3 per cent).

11. There has been a dramatic swing in the balance from a large deficit in 2008 to the world's biggest surplus. It shows that **domestic demand in the European crisis countries has been pushed back so much that resources have been set free for exports** – at the same time, imports have become less affordable. These are two of the positive effects of the deep recessions in the periphery of the euro area.

12. **Fiscal balances have also improved.** The aggregated deficit of euro area governments will be down to 3.0 per cent of GDP, again according to OECD forecasts (the EU Commission predicts 2.9 per cent). In 2009 the deficit had reached a record 6.4 per cent. For comparison, the US deficit will still be 5.4 per cent this year, not to speak of the likely Japanese shortfall

of 10.3 per cent. Taken as a whole, the euro area meets the Maastricht Treaty fiscal deficit criterion.

13. **Consumer price inflation, meanwhile, has fallen to 1.4 per cent** year-on-year in May and is now significantly below the ECB's target of somewhat less than 2 per cent. **The rate of 1.4 may look very low, but for an economist, the surprising thing is that it is not already negative, like in Japan.** The output gap this year is huge: over the 13 years through 2007, when the crisis began, the average annual growth rate of euro area real GDP had been 2.3 per cent. Six years later, in 2013, actual GDP will probably be 14.3 per cent below the old trend line and still 1.8 per cent lower than in 2007. The ECB has just forecast that real GDP will rise by 1.1 per cent in 2014, after falling by 0.6 per cent this year. In other words, the output gap is not yet shrinking. If this was the only determinant of future consumer prices, I would predict that deflation is not too far away.

centrifugal forces may yet tear the euro area apart

14. The low rate of capacity utilization is mirrored by labor market developments: the **unemployment rate has climbed from a low of 7.3 per cent in early 2008 to 12.2 percent last April.** Employment has shrunk by about 3½ per cent since that time. In spite of all this, average wages do not decline but continue to rise at rates of about 2 per cent. No matter how bad the economy, the institutional set-up – unionized wages, minimum wages and other arrangements – is such that European wages, the most important cost component, remain "sticky". I think this is the main reason why deflation has so far been avoided.

15. **Listing the positive consolidated data of the euro area, as in the paragraphs above, should not lead to the conclusion that things are fine. They are not. But the currency union as a whole is financially so robust that upcoming problems can be solved.** While the currency union is a long way from being a national economy where regional differences do not matter much because of a strong center and equally strong solidarity, when markets once again force the hands of policy makers, they will come up with adequate solutions.

16. Inflation rates do not differ much anymore, but **unemployment rates range from less than 5 per cent in Austria to 27 percent in Spain and Greece.** Differences in youth unemployment (<25 years) are even more extreme – from 7½ per cent in Germany to more than 55 per cent in Spain and Greece.

17. The same holds for fiscal balances: according to the Spring 2013 European Economic Forecast of the EU (page 147), there will be no, or almost no deficit in Germany, Estonia, Luxemburg and Finland, while **Ireland, Spain, Portugal and Slovenia will have deficits well in excess of 5 per cent** of their respective nominal GDPs. As bad as that looks, it is a big improvement since the crisis years 2009 and 2010. To everyone's relief, Italy has made great progress with regard to its deficit – it will be less than 3 per cent this year. The country is underappreciated by market participants.

18. Adjustments in unit labor costs are also in full swing – in general, **crisis countries have accepted that they must cut wages and boost productivity to reduce their dependence on imported capital. This is working surprisingly well** (at the expense of employment): Spain, Italy, Ireland, Portugal and Slovenia are all expected to run current account surpluses this year. This means they are now net exporters of capital and thus in the process of reducing

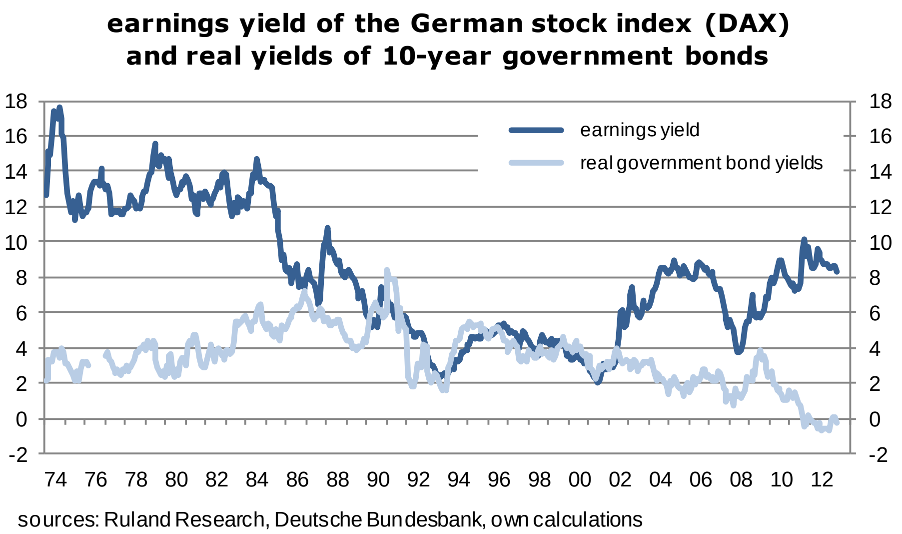
their foreign liabilities. The EU Commission expects that their unit labor costs will, on average, fall by 1 per cent this year from 2012 (page 143). The unit labor costs of Germany, Austria, Finland and Estonia, meanwhile, are rising at an average rate of plus 2.5 per cent. It is still a long way to go, but relative prices have begun to move in the right direction.

19. **On balance, the centrifugal forces of the euro area are still strong, but they are getting weaker.** Much of the effort to improve competitiveness can be explained by the expectation that the euro area will become something like a national economy over time where standards of living are converging. For the poorer member states this justifies today's painful adjustments. I think it is one of the driving forces in the euro area. It is rarely acknowledged by outside observers who are wedded to the notion of independent nation states, who find it strange that countries could give up national sovereignty. As it is, smaller states will actually have more control of their destiny if they sit at the common table than they have today, out there on their own.

20. **The banking union is the next big project towards a fiscal, if not a political union. Tangible progress in this regard would reduce the high risk premia and thus boost euro area stock prices, corporate bonds and the euro exchange rate.**

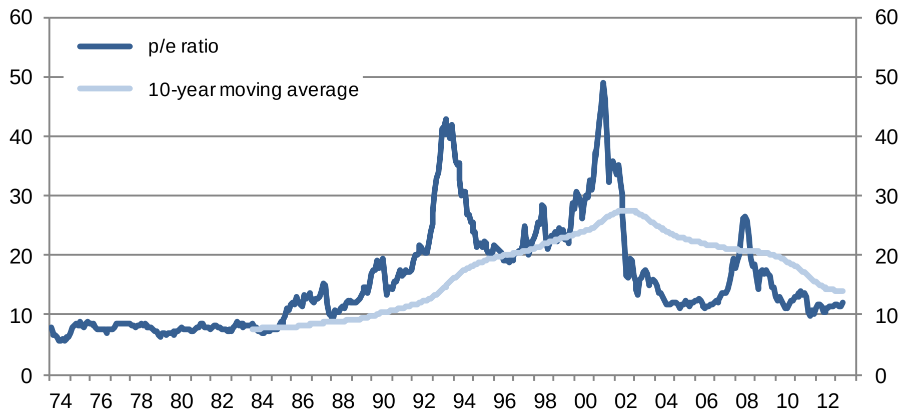
German (and euro area) risk premia are very high

21. To make a short detour at this point, the first of the two following graphs shows that the German equity **risk premium is presently extremely high, about 800 basis points**. Such a level was last seen in the mid-eighties. Reducing it to a more normal 500 would lift the DAX stock index from presently somewhat less than 8,000 to significantly above 10,000. This would reduce firms' cost of equity. Managers of European firms and their workers must wish that the euro will survive, and that there will be further progress towards a banking and fiscal union which removes the remaining doubts about the future of the euro. For comparison: the risk premium of the euro area EURO STOXX 50 is no less than 950 while that of the S&P 500 is only around 550 basis points. Equity investors are still scared by the euro.



22. Incidentally, another indicator suggests that German equities are presently quite cheap, in spite of the good run they had since March 2009 (19.8% p.a.). In the next graph, the p/e ratio of the DAX (10.4 last Friday, using 2014 consensus earnings forecasts) is compared to its 10-year average of about 14. Using such a long-time rather than next year's expected earnings acknowledges cyclical effects on earnings. Ten years is roughly the length of a business cycle. The approach has been popularized by Robert Shiller of Yale. Heino Ruland of Ruland Research has kindly provided me with the long p/e time series that he has estimated for the period before the DAX was introduced 25 years ago. A return of the p/e ratio to its 10-year average would push the index up by about one quarter to more than 10,000.

price-earnings ratio of the German stock index (DAX)



source: Ruland Research

the long road to a banking union in the euro area

23. To come back to the prospects of the euro area banking union, **progress will probably be slow from now on.** It was relatively easy to agree on a common supervisor, but bank resolutions are an altogether different issue. It means talking about money. Who will bear the costs of bankruptcies, and where should the money for recapitalizations come from? The €500bn European Stability Mechanism (ESM) is not the right vehicle because it is intended to rescue sovereigns, and it is based on macroeconomic and structural conditionality.

24. The German side insists that problems caused by so-called (non-performing) legacy assets should remain in the national responsibility; the new resolution authority would take care of anything that happened after its establishment. No free lunch, and moral hazard is to be avoided! However, if under pressure from the majority of other member countries – and markets! -, Germany will usually give in. This happened once again last Thursday: **troubled systemically relevant euro area banks which are economically viable will be able to tap the ESM for a total of €60bn.** They and the governments of their home countries must promise to address the root causes of their problems. Funds can only be activated once shareholders (owners) and creditors have made their contributions (the so-called bail-ins). In any case, no money will flow before the second half of 2014 when the euro area banking supervisor has started to operate (at the ECB). €60bn is a fairly small sum in the scheme of things, but it is another contribution to the stabilization of the euro.

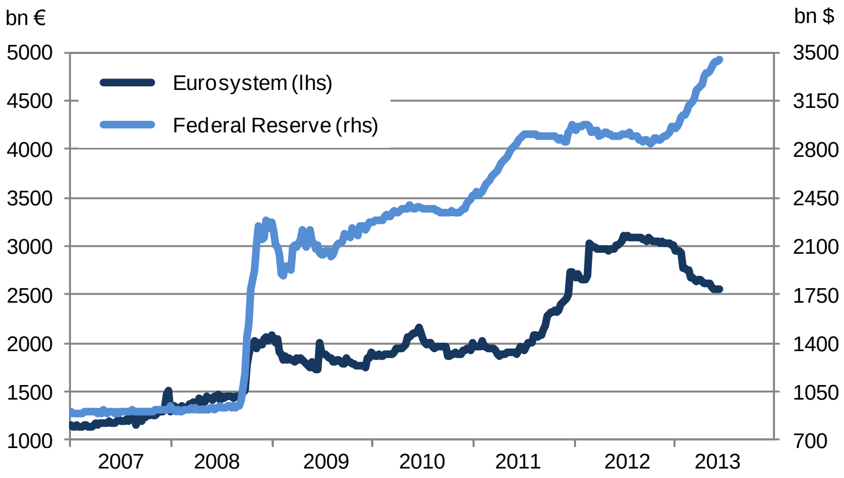
25. Reaching a comprehensive agreement about a euro area bank resolution authority will probably take years, no matter who wins the federal elections in Germany next September. A lot of money and potentially uncontrollable risks for the taxpayers in creditor countries are involved. For this reason alone, euro area equity risk premia will remain fairly high for some time. It also means that **a large euro appreciation is less likely.** But this is not bad. In fact, it is exactly what is needed in the present environment of slow growth and high unemployment: the adjustment programs in crisis countries have a better chance to succeed if the euro is not too strong.

euro area banks are still shaky

26. The banking sector of the euro area is not out of the woods yet and could cause problems anytime. The largest private banks have an average price-to-book ratio in the order of 0.5; the number for comparable banks in the US is 1.0. **Market participants are convinced that the books of Italian, French, German, Spanish, Austrian and other European banks are still full of non-performing loans (NPLs) which could wipe out their slim equity bases.** The Bank of Italy has reported that the share of NPLs in total loans is 13.4 per cent (Dec. 2012), while the Bank of Spain put the share of doubtful loans at 10.9 per cent (April 2013). Things are even worse in Greece (25%) and Ireland (19%) (from a J.P. Morgan analysis, quoted in FT Alphaville).

27. **These numbers, together with the deep recession in the euro area mean that the ECB will stick to its ultra-loose policies**; it is actually considering other options to get the economy going again, including negative interest rates on the deposit facility (for banks) and expanding its balance sheet again – it had shrunk recently (see the graph below). The banking sector as a whole had begun to repay its 3-year borrowings from the ECB as lending to non-banks in the euro area remains depressed (-0.1% y/y in April), reflecting on-going deleveraging. **As far as liquidity and the level of the ECB refinancing rate are concerned, euro area bond and stock markets will continue to be well supported.**

central bank balance sheets*)



*) total assets

sources: Federal Reserve, ECB

28. **What will happen if a "systemically important" bank blows up one day, with domino effects potentially bringing down the whole banking sector and the economy as well? In such a case, the resources of the member states and the ESM would quickly be depleted. Establishing a powerful area-wide resolution mechanism would probably be seen as the only way out.** Various defense lines in countries such as Germany or Holland would have to be given up. A full-fledged banking (and fiscal) union might thus come about earlier than I, and the markets, are presently assuming. **For euro area stock markets this would be good news, though, after the initial shock that is. It would also trigger the next round of spread tightening in government bond markets – and push up the euro exchange rate.**

lucky country USA

29. **As to the second global risk listed in the introduction, is the US economy indeed on a self-sustaining growth path? Has it been able to shrug off the effects of tight fiscal policies? And why is it doing so well compared to the euro area?** After all, the implosion of America's sub-prime mortgage markets in the summer of 2007 had been the epicenter of the financial crisis in the OECD area. In the four years since 2010, US real GDP has steadily expanded at a rate of 2 per cent a year while the four-year average of the euro area has been a measly 0.6 per cent – it includes the new recession years of 2012 and 2013. One explanation is that debt levels have been reduced much faster than in the euro area or in Japan. It has helped that about 50 per cent of borrowed funds had come from capital markets, not from banks. In the euro area, the ratio is about 10 per cent. In a financial crisis it is an advantage if the banking sector is relatively small! Moreover, the Treasury had pushed through the re-capitalization of troubled banks forcefully and at an early stage.

30. The S&P 500 stock index has gained 135 per cent since the cyclical low of March 2009, compared to only 41 per cent for the EURO STOXX 50, and it trades at no less than 2.35 times its book value (EURO STOXX: 1.15). Financial investors like US stocks and shy away from European stocks. Incidentally, at 1.75 the price-to-book ratio of the stocks in Britain's FTSE 100 is also considerably higher than that of euro area stocks.

31. **The US is presently playing in a different league. On the other hand, assets are relatively expensive** (except for real estate): investors are willing to pay a price for the fact that the country has powerful problem solvers in Washington whereas the euro area has nothing comparable yet. No one can call the European minister of finance.

32. **Seen from inside the US, the recovery from the Great Recession is not at all spectacular though**. After real GDP's 4.6 per cent decline (Q1 2008 to Q2 2009) it would have been normal to see it increase at rates of more than 4 per cent for several years. This has not happened.

33. **Employment is also disappointing**: it is still 1.7 per cent below its pre-crisis peak of end-2007. The unemployment rate has come down from 10.0 in October 2009 to 7.6 per cent this May, and thus close to Mr Bernanke's new 7 per cent trigger, but policy makers and analysts are aware that this success is largely artificial: many workers are so discouraged that they have stopped to look for jobs – and are thus not counted as unemployed any more. Put differently: the unemployment rate has partly fallen because the so-called participation rate has fallen. Without its reduction from 66.4 per cent of the potential labor force at the end of

2006 (the last cyclical high) to 63.4 per cent in May 2013, the official unemployment rate would still be in the order of 10 per cent.

Fed has unsettled markets – no reason to be so nervous

34. The QE3 $85bn-per-month bond-buying program of the Fed will be phased out as the unemployment rate approaches 7 per cent (this milestone had been moved up from a more ambitious 6.5 per cent). The overall economic situation is still quite bad, though. Growth has gained momentum which can justify some reduction in monetary policy support, but **the recovery is not yet self-sustaining**. Fiscal policies remain restrictive. The economy is still operating far below its potential output; actual real GDP this year is about 13 per cent below the extrapolated trend line based on the average growth recorded in the ten years through 2007. And the output gap is not shrinking as long as GDP expands at rates of only 2 per cent.

35. **The large output gap and the significant underemployment of the labor force suggest that US inflation will remain subdued and below the Fed's target.** Here are the most recent readings: Import prices -1.9% y/y, producer prices +1.7% y/y, consumer prices +1.4% y/y, core personal consumption expenditure deflator (ex-food and energy) +1.3% annualized, unit labor costs minus 4.3% annualized. All indices are trending down. US inflation-linked bonds show that 5 to 30-year inflation expectations are around 2 per cent: Mr. Bernanke's announcement that QE3 would come to an end sometime next year did not have a noticeable impact on the main driver of long-term yields.

36. For the time being, the data suggest that the Fed has no problem defending its aggressive money printing and a Fed funds rate of almost zero (0.1% on Friday). The **ghost of deflation has not yet been scared away.**

37. **For US securities markets, this has the following implications:**
    - short-term rates will remain anchored by the near-zero policy rate;
    - funding costs remain extremely low (3-month LIBOR is 0.27%);
    - government bond yields cannot move too far away from these levels – they are buying opportunities if they do;
    - the rate of expansion of central bank money will go from extremely high, to high, to modest, to zero – the process will take four to six quarters;
    - even after last week's run-up, bond yields are still quite low; equities are no longer cheap but they remain a good alternative to bonds (the S&P 500 dividend yield is 2.15%).

emerging economies out of favor

38. It is likely that the **flood of dollars** that has been inundating global capital markets – especially those of countries that intervened on FX markets to prevent an appreciation of their currencies against the greenback – **will turn into a trickle**. An important support for their currencies and securities is thus about to be removed. Commodity producing countries are negatively affected as well.

39. **Fundamentally, nothing has really changed last week.** The Fed has announced that it thinks about taking away one of the two punch bowls it had put in front of potential borrowers: over-generous liquidity. The other bowl – record low interest rates – will stay where it is. The collapsing gold price (32% down from its Sep 2011 high) shows that

inflation expectations are certainly not rising. **For market participants other factors are sometimes more important, such as central banks' policy statements.** They have been aware that monetary policies could only become tighter, given how ultra-loose they are, and don't want to be caught sitting on overpriced assets.

40. **The change in sentiment has hit emerging economies' stock, bond and currency markets particularly hard. They had been the main beneficiaries of the Fed's dollar printing.** The combination of rapid growth and sound fundamentals had made them attractive alternatives for investors disappointed by the low yields in developed markets. Real activity had also been boosted by these capital inflows and the resulting low costs of funds. However, much of it was focused on real estate, a sector prone to bubbles. Disillusionment about future corporate earnings growth had already set in between the end of 2010 and early 2011. Since that time, which coincided with the last peak of commodity indices (GSCI, for instance), Brazilian, Russian, Indian and Chinese – the BRICs' – stock markets have been on a falling trend (only India has been fairly resilient).

41. **In terms of GDP growth, emerging economies as a group are still outpacing rich countries by a wide margin.** According to the IMF's April World Economic Outlook, it will be 5.3 versus 1.2 percent year-on-year in 2013. This is on the basis of purchasing power parity exchange rates. Using actual exchange rates and adjusting for the data that have come in after the publication of the report, it is something like 4.5 versus 1.0 percent.

42. **As impressive as this difference in economic performance is, it is not necessarily a good guide for investors who wonder where to put their money.** Stock markets in developed countries have been doing much better than those in emerging and developing economies for the past two and a half years. This is because corporate earnings are not necessarily driven by the growth of GDP in their home countries. Most of them have become multi-nationals for which developments in global markets, exchange rates, changes in international tax regimes, trade barriers and ease of doing business abroad are the main determinants of their profits, and thus their stock prices.

China tries to slow its credit boom

43. That the third global risk listed at the beginning of this analysis – a significant slowing of China's economic growth – is no longer on the radar screens of financial investors may be too bold a statement. **In most forecasts that I see, the question is only whether real GDP will exceed last year's average by 7½ or 8 per cent. Even though this is less than the 10.1 per cent average of the six years through 2012 it would still be an extremely good result, and be very positive for the rest of the world.**

44. China has become the world's main growth engine. Its nominal GDP this year will be no less than €7.0tr, compared to America's €12.4tr, euroland's €9.5tr and Japan's €3.7tr. The OECD expects its imports of goods and services to reach €1.7tr in 2013 (US €2.1tr, euroland €2.4tr, Japan €0.7tr). **For at least half a decade, the annual additions to global GDP have been larger than those of the US or the euro area.** In other words, if China coughs, the rest of the world catches pneumonia, something that used to be said about the US. China matters.

45. Policy makers are concerned that credit growth has been too fast, much faster than the growth rate of nominal GDP. In order to curtail it they have begun to tighten interbank rates. Over the past three weeks, 3-month Shibor has risen from 3.9 to 5.8 per cent, and 7-day money costs 9.2 per cent, compared to less than 3 per cent around the middle of May.

46. **Why are policy makers concerned?** They obviously like fast economic growth, but they seem to be even more afraid of borrowing binges which create asset price bubbles in housing and infrastructure. Property prices seem to have gone through the roof lately. Bubbles must be fought early on because when they pop they tend to cause havoc across the economy. Debt reduction can last many years, as we know, and reduce economic growth a lot. Acting now and accepting a brief slump must seem a better strategy than to let credit growth rip and then face sluggish growth for a decade, the new government's term of office.

47. **In Q1, China's real GDP had expanded at a disappointing annualized rate of 6.4 per cent.** Exports to the US and Europe, the two most important destinations, have been shrinking three months in a row. Imports over the twelve months to May have increased by 5.3 per cent and thus by much less than nominal GDP. This is quite worrying.

48. A leading index such as the non-manufacturing purchasing managers' index (PMI), while still pointing to expansion, is on a clear downtrend. The manufacturing PMI hovers just barely above the 50-line which separates expansion and decline of output. Tighter monetary policies are thus coming at a critical time, when the economy is not so strong anymore.

49. **Will there be a recession in China? I think this is quite unlikely.** Because of its high savings rate, the world's largest stock of foreign reserves, non-existent foreign debt, low inflation (2.3% y/y in Q2), a miniscule fiscal deficit and a huge potential for domestic demand to catch up with rich countries it can be expected that the country will fairly quickly overcome the present lull if policy makers switch to a more expansionary strategy one day again. Monetary and fiscal policies still seem to have the desired effects on final demand. This may be wishful thinking.

most commodity markets are trending down

50. Especially for commodity markets the news from China is bad. The country's demand makes or breaks global rallies. **The Goldman Sachs Commodity Index which has been on a falling trend since spring 2011** – it's down by one quarter – is not likely to turn up for good in the foreseeable future, especially if the dollar flood does indeed end over the course of the next twelve months. Also keep in mind that from a historical perspective the level of commodity prices remains quite elevated.

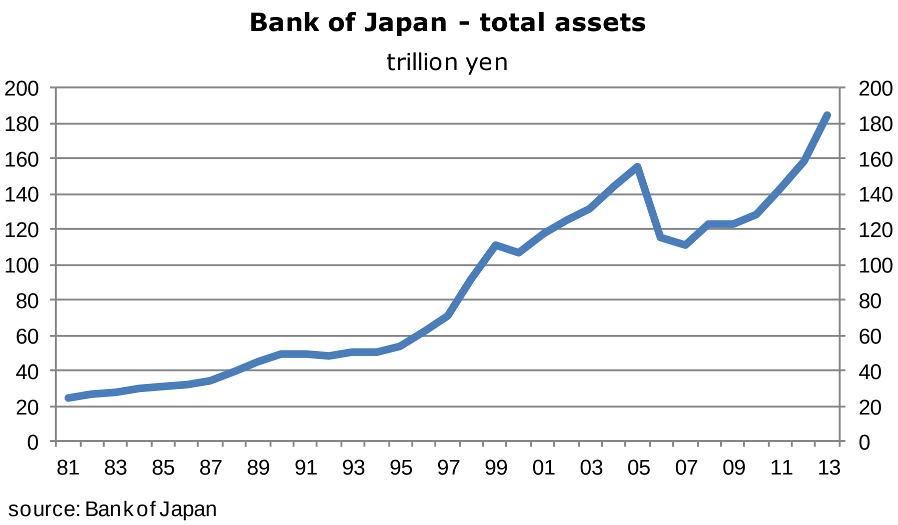
51. The EU Commission, in its spring forecast, predicts that by 2014 the price of food will have fallen three years in a row (in dollar terms, p. 160); the prices of minerals and metals have fallen steeply last year and seem to be stabilizing on this level. Fuel products are seen to decline by about 5 per cent both this year and next. **Brent will cost $99 on average in 2014**. Oil producers can very well live with such a price.

52. One factor that is often overlooked when guessing where commodity prices are moving is the effect of prices on the supply side. The commodity price boom had led to a **huge expansion of potential output which is now pushing down indices.**

53. For countries such as **Russia, South Africa or Australia** which depend on commodity production, growth in 2013 will be much slower than in previous years, something in the order of 2 to 2½ per cent year-on-year. They experience some pain, but are still in a fairly comfortable position. Genuine recessions are not on the cards. But I do expect that their currencies will depreciate further in the absence of indications that a turn-around of commodity prices is imminent.

Japan pulls all stops to fight deflation

54. **How is the outlook for Japan?** Have the Abe government and the new governor of the Bank of Japan made any progress towards faster economic growth and an inflation rate of 2 per cent – will Japan finally overcome deflation? The chart shows that monetary expansion has been just as aggressive as in the US.



55. To **quote from the OECD's Economic Outlook** (page 73): "Japan has rebounded strongly from its 2012 recession, led by fiscal and monetary policy stimulus. A fiscal package introduced in early 2013 and a new monetary policy framework aimed at achieving the 2% inflation target, accompanied by a weakening yen, are boosting output and confidence. Aided by a recovery in world trade, output growth is projected to be close to 1½% in 2013 and 2014, which will help push inflation into positive territory."

56. It is too early to tell whether deflation can indeed be overcome. Consumer prices and the GDP deflator are still well below last year's levels; so are unit labor costs. But **real GDP has expanded at an annualized rate of 4.1 per cent in Q1 and seems on track for 2½ to 3% annualized growth rates for the rest of the year. This is a nice early success of the new strategy.**

57. The output gap must be huge after many years of sub-par growth, so it will **not be easy to raise inflation in the near term**. Bond yields have increased from a low of 0.44% in early April to 0.87% now (10y JGBs), a tentative sign that inflation expectations have picked up. I say "tentative" because the real component of yields has probably increased as well.

58. It certainly **helps that both the dollar and the euro have appreciated by about 35 per cent against the yen over the past year**. At some point, further yen weakness will meet stronger resistance from trading partners; especially China and the US may soon come to the limits of their tolerance with regard to the yen exchange rate. This puts also a limit on further monetary expansion. Moreover, for fundamental reasons, the yen exchange rate will turn around at some point, in response to an improvement of the balance of trade and larger net inflows into the country's stock markets.

59. The **bottom line** is that the yen exchange rate and bond markets will remain weak for some time while stocks and property are well supported. There is a flight into real assets such as real estate investment trusts (REITS).