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Wermuth's
Investment Outlook

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How to benefit from structural change

by Dieter Wermuth*

1. Zero interest rates are not a reason to despair. **As long as the world economy continues to grow, there will be opportunities for profitable financial investments.** And global real GDP does grow, if not as fast as in the years immediately before the financial crisis. The present rates of 2½ percent (at actual exchange rates) to 3 percent (at purchasing power parities PPP) are not much lower than long-term averages. Moreover, in the aggregate, annual growth rates have been positive for many decades, with the exception of the stagnation in 2009 (PPP terms). The world economy is not very volatile, and has considerable momentum, thanks to the catching-up and leap-frogging processes in emerging economies and the high investment ratios there. Stagnation and "lowflation" may be issues in the euro area and Japan, but not globally.

2. The challenge is to find the assets which will do better than the average, and to short those that are falling behind. **Structural change remains as rapid as ever because in the poorer countries the way of living and producing is still very different from that in the rich countries**. As per capita incomes converge over time, consumption patterns and production functions will become similar: energy demand will rise, just as the share of imported goods, people will move to larger apartments and houses, they will travel more and increase their demand for services in general, while expenses for infrastructure such as roads, railroads, water treatment or the internet will rise much faster than in the rich countries, and so on.

Betting on emerging economies

3. Obviously, we are not talking about a smooth path. Investment in far-away places is fraught with all kinds of risks: political upheavals, corruption, a weak rule of law, or unpredictable institutional changes in sensitive areas such as cross-border capital flows, taxes, price setting, labor laws or property rights. **Business cycles have usually much wider amplitudes than in the more saturated economies, especially in commodity exporting countries.** To compensate for these risks, expected returns on investment must be higher than in the European Union, North America or Japan. Transparency International's corruption index or the World Bank's "ease of doing business" index provide first approximations of the risks investors have to be aware of.

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4. Investors are often not fully aware of the **risks of credit-driven asset price bubbles in countries and industry sectors that benefit from structural changes.** They tend to get carried away by rapid economic growth, seemingly undervalued assets, and hype about the bright future of real estate, equities or commodities. In an environment where everybody is enthusiastic and expects asset prices to move in only one direction – up – it is often not easy to stay cool and to stick to time-honored valuation principles.

5. When the underlying cash flow from assets is generally regarded as irrelevant compared to potential capital gains, alarm bells should go on. **Exaggerated pessimism, the expectation that things will never get better again, is also part of the picture**. Fire sales, triggered by the need for cash, frequently re-enforce the downtrend. It takes very level-headed risk takers to enter a market when all evidence points in only one direction – down.

6. **Exchange rates of less developed economies also tend to overshoot**, especially when central banks try to peg them to the dollar or euro: if they lose contact to fundamentals such as the balance on current account or interest rate and inflation differentials, the adjustment can be violent. For foreigners, the depreciation of a currency can easily wipe out some or all of the previous gains.

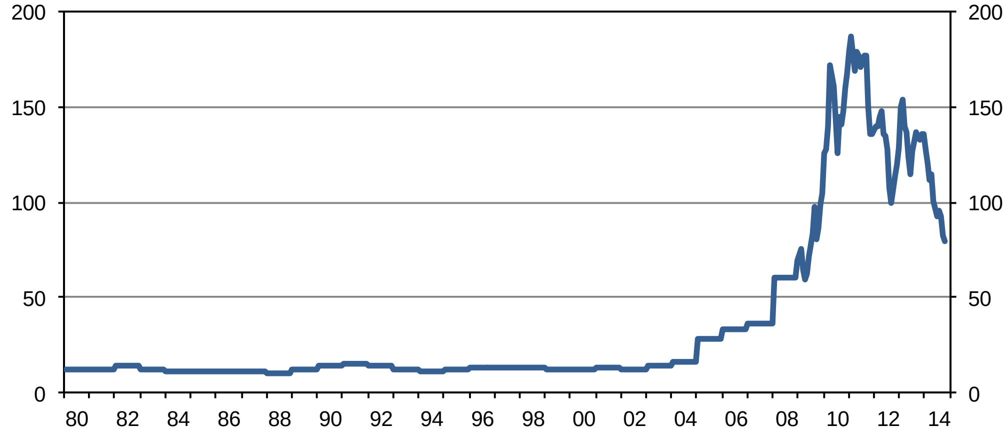
Structural changes and bubbles

7. **Stories of structural changes are usually plausible, but these changes do rarely occur overnight. One example is climate change where some effects on the economy will not show up for decades or even centuries** – which means the financial benefits of climate change abatement will probably remain elusive for a longer period than initially expected; formerly zealous investors run out of cash, credit lines and patience much earlier than they had imagined. In general, the burn rate in this infant industry is considerable and many disillusioned fund managers have stopped looking at this sector – prematurely, I think. The arguments for "green" investments still hold, but the time frame is longer. In addition, the rapid expansion of alternative sources of energy has contributed to the recent crash of oil prices which in turn makes it less attractive to bet on wind and solar power.

8. **Something similar has recently occurred in a commodity such as iron ore**. The economic catching-up process in China and other emerging markets was – and is – obviously steel intensive. Think high-rise office and apartment buildings, factories, container terminals, ships, high speed railways, cars or motorways. The following chart shows that iron prices rose by about 1,400 (!) percent between 2002 and 2010 and then collapsed (-57 percent) as production increased and demand declined, both a result of the previous price inflation and the slow-down of the global economy. Structural changes had been correctly anticipated, but we now have overcapacities and falling prices, including the share prices of market leaders BHP Billiton and Rio Tinto.

Iron ore

US$ per metric tonne



source: International Monetary Fund

9. **So these are plenty of caveats that investors should be aware of before betting on those structural changes: the environment is very volatile, with an unusually large number of variables that can have an impact on asset prices. While the risks are high, rewards are also high, if only for the skilled operator. In the zero-interest rate environment in safe-haven countries, the case for shares in companies which will be the winners – and losers – in the never-ending restructuring of the world economy remains compelling. Let us now have a very top-down look at some key indicators of the secular changes that are under way in the world economy.**

Globalization remains the most momentous structural change

10. Most investors are aware that globalization moves ahead in leaps and bounds, sometimes slower, sometimes faster. In recessions or periods of very slow global growth, it is usually one of the victims. But if we look at medium term trends, for instance at ten-year moving or other long-term averages, as in the following table, we see that world trade volumes outperform global real GDP by factors 1.6 to 2.3, an indication that the international division of labor, ie, of production, moves ahead rapidly.

world trade and global GDP

	world trade volumes	global real GDP*)	income elasticity of world trade
	average annual percentage change		
	(1)	*(2)*	*(3)=(1)/(2)*
1980-1993	4,6	2,9	1,6
1994-2008	7,2	3,1	2,3
2009-2014	3,1	2,1	1,5

*) at market exchange rates
source: IMF

11. **The reasons for this stable trend are easy to find: it is mostly economies of scale**, made possible by continuously improved information about foreign markets, the gradual dismantling of trade barriers and rapidly falling costs of transportation. To ship a container from China to Rotterdam costs about €1,000 these days; new vessels can carry no less than 14,000 of these. Air freight is also getting cheaper, in absolute and relative terms, as the number and average size of airplanes rises relentlessly. For firms, travel costs have become an almost negligible expense, so it's not just the internet which provides information about international production and consumption patterns but visits on the ground as well. It helps that English is increasingly the world's lingua franca, even in remote areas.

12. **When will this process stop? I think it has some time to run** because of institutional differences between countries, barriers of trade and scores of freely floating exchange rates. The world economy is obviously still very different from a national economy, even though the trend is toward an increasing degree of similarity. From an investor's perspective this suggests to **focus on participations in firms that do well in the international market place.**

13. More and more of these will be headquartered in emerging and developing countries, simply because these are growing much faster than the advanced economies. Roughly speaking, the two groups have an equal share in global GDP today (50/50). Now assume that for the next 25 years the average growth rate in the poor countries will be 4½ percent, compared to 2 percent in the rich part of the world: at the end of the period, ie, in 2039, the share of the former will have risen to 65 percent, and to 70 percent soon after. And this would not be the end because they will account for at least 90 percent of the world's population.

14. As can be seen in the next table, the growth assumptions made in the paragraph above are rather conservative. Real GDP growth rates in emerging economies have averaged 5.1 percent since 1994, not just the assumed 4½ percent, while the average growth rate of the advanced economies has been 1.9 percent. Over the course, and in the wake of, the financial crisis, the growth differential was even more pronounced.

15. **Extrapolating past trends is only plausible if the countries that try to catch up are actually able to create the institutions which are needed at the more advanced stages of growth**, when the low-hanging fruits have been picked. From a certain point onwards, high value-added production requires the rule of law, entrepreneurial freedom, open borders, an efficient infrastructure and a labor force that has the software and hardware skills needed in modern production processes. If these are not given, growth will stall. Russia, Brazil, South Africa, Greece and to some extent even Italy show that without fundamental reforms of the institutional set-up the growth momentum can get lost. Not all emerging economies are automatically characterized by high growth rates and high rates of return.

16. From an investor's perspective, **not all "safe haven countries" are members of the OECD anymore: Asia's emerging economies in particular have recently been much more shock resistant**, thanks to relatively small banking sectors, high savings rates and currency reserves, and small government budget deficits. Given these parameters, Keynesian recipes are still effective there. In other words, the countries still have the policy tools to prevent deep

recessions. There are no indications so far that for the group as a whole their catching-up processes are about to end. I'll have a look at the risk of bubbles toward the end of this text.

global industrial production and GDP				
	real GDP[1)]		industrial production[2)]	
	Advanced economies[3)]	Emerging market and developing economies[4)]	Advanced economies[5)]	Emerging market and developing economies[6)]
	average annual percentage change			
1980-1993	2,8	3,5	-	-
1994-2008	2,7	5,5	2,0	5,8
2009-2014	1,0	5,2	-0,1	5,1

1) PPP – 2) ex construction; at market exchange rates – 3) 36 countries – 4) 159 countries – 5) 27 countries – 6) 54 countries
sources: IMF, CPB Netherlands; own calculations

17. As one would expect, **industrial production in emerging economies is still rising somewhat faster than real GDP, the opposite of what we observe in rich countries**. But this is about to end. Industrial and food production is bound to go the way of farming in the West: large productivity gains will reduce the share of labor in the industrial production function. No need to worry, though: even a shrinking work force can supply the world with all the stuff it needs. In the rich countries today, farmers account for less than 2 percent of overall employment and they produce more than we can eat!

18. Secular structural changes mean that most of the future growth stories in the emerging world will be in software, retailing, logistics, tourism, education, health services, business consulting and the like.

19. **Tapping into the ongoing agricultural revolution in the "third world" is another suggestion to investors with a focus on structural changes**: firms which raise the productivity of farm workers and the land on which they operate are obvious targets. Multinational producers of farming equipment, high-yield seeds, fertilizers, warehouses or irrigation systems come to mind in this context.

Demographics lead to new patterns of consumption and production

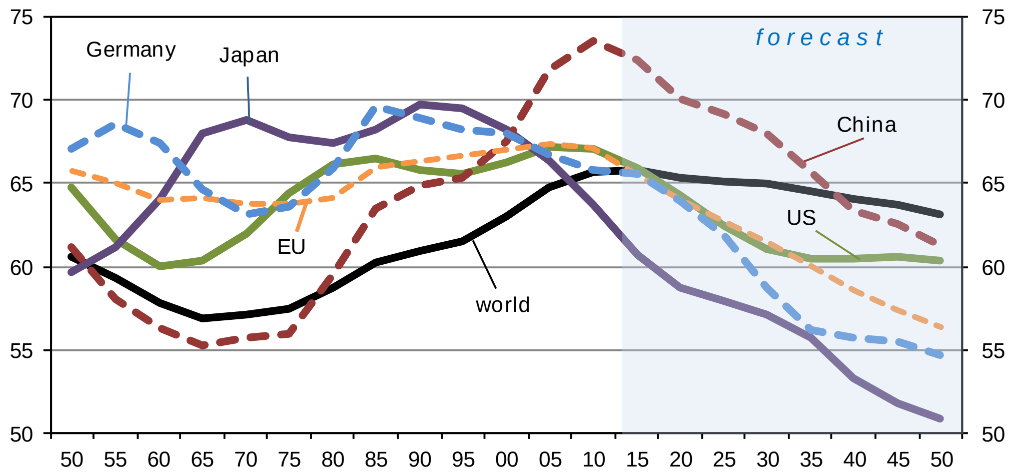
20. **A main driver of structural changes is demographics.** Not only in Japan, but also in Germany and the European Union as a whole, the working-age population is shrinking. Even China is approaching an inflection point. Globally, the population grows at slower and slower rates, probably in response to the fairly rapid increase of per capita incomes – it will still reach about 10 billion by 2050, compared to 7.2 billion today, given the underlying momentum.

21. But it is fairly certain that **the ratio of retired to active workers will steadily deteriorate**. This is another secular trend. It slows potential GDP growth, reduces the need to invest and

boosts saving for retirement (also because of the longer expected lifespan after leaving the work force). Combined with today's fiscal retrenchment, corporate cash hoarding and rising inequality, these factors reduce the real interest rate which brings saving and investment into balance – at a low if not negative rate. Only when retirees begin to draw on their accumulated savings will real interest rates rise back into positive territory and perhaps to the historical averages of between 2½ and 3 percent (a detailed discussion of these issues can be found in the Economist of Nov. 22, page 72).

the vanishing worker

working-age population, % of total



sources: UN World Population Prospects: 2012 Revision; own calculations

22. Financial investors can benefit from these demographic changes. Most obviously, **firms that cater to the old will expand relatively fast**. This includes medical services such as hospital chains, pharmaceuticals, geriatric care, housing projects for the elderly in warm parts of the world, or cruise ship operators.

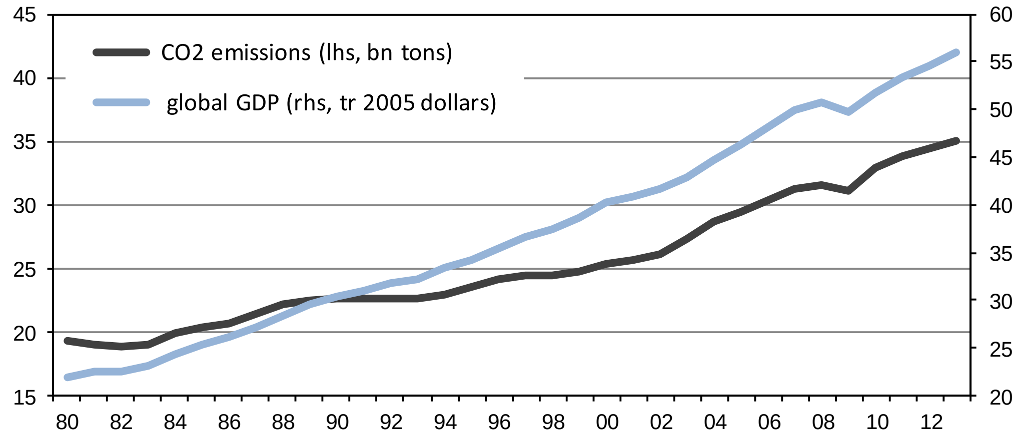
The case for green investments

23. Since the world population will expand by almost one half over the coming three and a half decades, **it is almost inevitable that in spite of all the efforts to stop the process the environment will continue to deteriorate further**. The pollution of air, water and land will get worse before things get better. China, for instance, expects CO2 emissions to rise until 2031 before they will finally start declining. Also: while the countryside gets emptier in almost all countries, caused by large productivity gains in agriculture, the concentration of the population in metropolitan areas and megacities keeps rising. Traffic congestion becomes an increasingly annoying feature of daily life.

24. For investors, the implications of these unpleasant developments are clear: **firms that offer products or services which reverse the deterioration of the quality of life can be expected to do well in the market place**. They may improve energy efficiency, provide energy from renewable sources, prevent pollution or clean up the environment, or recycle waste. Other ideas relate to public transportation, taxi, car and bicycle sharing, or home deliveries by

supermarkets. Overall, real GDP growth may be slow in the rich countries, but many activities are simultaneously expanding quickly.

global CO_2 emissions and real GDP

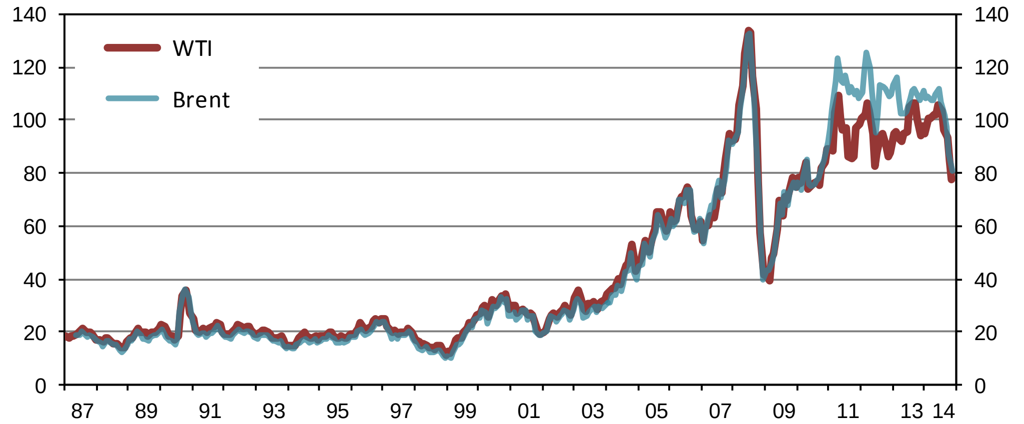


sources: BP Statistical Review of World Energy June 2014, IMF; own calculations

25. **Another structural change in this connection is the new glut of energy supply**. The historically high level of oil prices has stimulated oil exploration and production, investments and research in renewable energy, conservation of energy and the use of substitutes (such as the climate killer lignite coal or, in Japan, nuclear power**). So energy prices are now falling and many of the companies that started to invest in new production facilities over the past five years are now struggling.** They had assumed that prices would remain high or even rise long-term and are now sitting on "stranded assets" which need to be written down. Investors have already begun to open short positions in such firms. The larger the share of income from upstream activities, the more they are exposed, and the closer they are to consumer services the safer they are.

oil price

dollars per barrel, monthly averages



source: Thomson Reuters

26. If one looks closely, **there are more structural changes under way than one would expect** – and thus investment opportunities –, even in slow-growing European countries or Japan. I mention just a few, in no particular order:

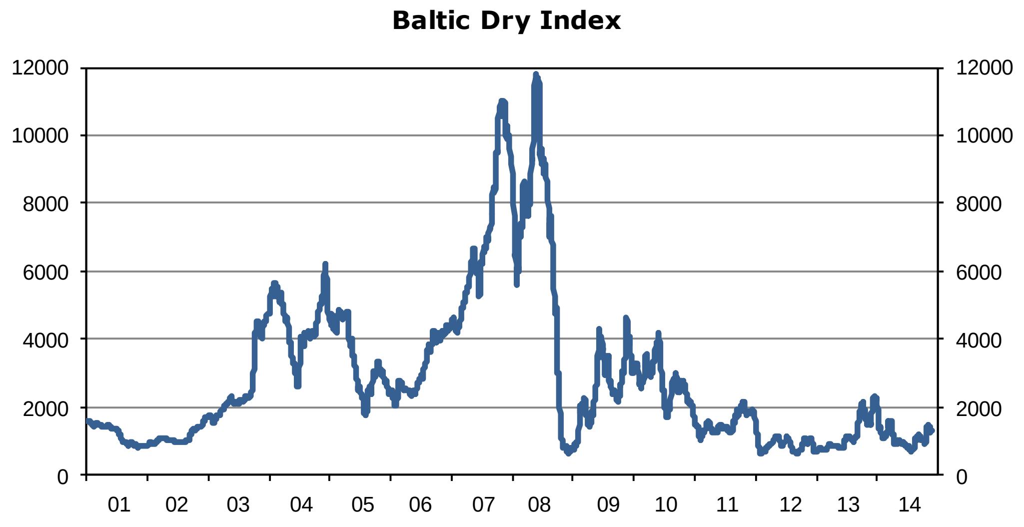
- **Banks will come increasingly under pressure from IT firms** which try to take away from them technology-intensive activities such as payment transactions; especially banks in the euro area are exposed, given their slim equity basis and expensive workforces.
- **Retailing is undergoing a revolution**; internet shopping takes away an increasingly large share of the business from physical retailers; this has positive effects on logistics companies and negative effects on shops with high overhead costs and no obvious competitive advantages.
- **It could just be that disinflation and deflation will stay with us for longer than we like.** This would be a significant structural change, not only for monetary policy makers. For investors it would reduce or eliminate the need to hedge against inflation. Gold would be a victim, probably metals in general, but also real estate where the speculative element would no longer be in play when people think about buying a home.

Where are today's bubbles?

27. Following are some remarks about the risk that expectations about structural changes have already led to asset price bubbles in the markets on the sunny side of these developments. Bubbles are dangerous if the market concerned is large and if the betting on ever-rising asset prices is financed with other people's money. When they pop, the owners of the assets typically find themselves financially under water, with net negative equity which forces them to repay their debt in order to regain their creditworthiness. This leads to less spending, rising output gaps and downward pressure on consumer prices.

28. Investors like emerging economies – that's where the growth is these days. But so far, equity risk premia are reasonable, with the exceptions of India, Indonesia, Malaysia, the Philippines, Thailand, Mexico, Chile, Portugal, Greece and the Czech Republic which all look expensive, but not overly so. On the other hand, Russia is outright cheap, while China, Hong Kong, South Korea, Brazil, Argentina and Turkey look about right. Singapore, Taiwan and South Africa are at the borderline between fair value and being expensive. **On balance, the popularity of emerging economies has not yet produced bubbles about which we should worry.**

29. **Investors did also bet on the rapid expansion of world trade which has indeed taken place.** One way to do this was to put money on freight rate futures, ship builders and shipping companies. The result of the strategy was fairly disastrous because everybody had the same idea, resulting in considerable overcapacities and a steep fall, actually a crash of freight rates.



source: Bloomberg

30. While this has been a bubble in a relatively small corner of the world economy, **a bubble in world bond markets would be an altogether different matter.** If disinflation, deflation and near-zero policy rates in the rich countries are here to stay, ie, if we are experiencing a genuine structural change, then investors can be rather relaxed and hold on to their fixed-income securities. But what if not? Assume an average increase in OECD country government bond yields by two percentage points and an average duration of six years: this would reduce the book value of outstanding government debt by something in the order of $5.4trillion. The number is larger than the nominal GDP of Japan.

31. There is **some probability that anemic growth in the capital-rich West will continue for a while as restrictive fiscal policies combined with ongoing deleveraging processes hold back final demand**. In Japan, after all, deflation persists now for more than 15 years (the fact that government budget deficits have usually been close to 10 percent of GDP is not a sign of loose fiscal policies: if one takes account of the huge output gap, such deficits may actually have been too small to have a positive impact on overall demand!). And the euro area more and more resembles Japan. In other words, it is not unlikely that “lowflation” will be around for another decade there – which will prevent a bond market crash. Things are different in the US where deleveraging has been accomplished much faster than in Europe: growth is now both robust and self-sustaining.

32. In the end, once deleveraging has been accomplished or after a shake-out recession, all the money printing of the past years will lead to higher inflation rates and bond yields**. I cannot believe that zero money market rates will be with us forever.** Even in the gold standard system of the nineteenth century deflationary periods were always replaced by inflationary periods.

33. **A final issue is the question of real estate bubbles in China.** To be honest, I cannot tell. I know that investment ratios have long been in excess of 40 percent of GDP and I am sure that a lot of that capital spending has been in assets which do not earn their money, as in Shanghai apartments which often stay empty for years. Credit volumes have certainly

increased at breathtaking rates – which suggests that the conditions for a real estate crash are in place. But I am also impressed by the facts that China has not been borrowing abroad, just the opposite, that accumulated reserves are gigantic, and that the banking sector is state controlled. In a crisis, banks don’t need to be nationalized at taxpayers’ expense, they are already nationalized.