



Wermuth's Investment Outlook

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Asset allocation at a time of low real interest rates

by Dieter Wermuth^{*}

1. Following is a list of the main drivers of asset markets. I argue that

- the growth of the world economy is slowing in the wake of China's structural problems,
- but that it will remain in the order of 3 percent, about one percentage point less than in the decade before the financial crisis;
- output gaps are still fairly large, employment growth is robust while productivity continues to disappoint,
- the commodity super-cycle has ended for good, prices will not reach previous highs for a long time,
- wage and consumer price inflation is and will remain subdued, as are inflation expectations, even in the US,
- central banks will keep their foot on the accelerator throughout this year, if not longer, as risks for the economy and prices are seen to be skewed to the downside,
- continental European economies and Japan continue to be stuck in liquidity traps - fiscal policies are not yet allowed to come to the rescue,
- "unconventional monetary policies" such as quantitative easing and negative interest rates have neither ignited inflation nor have they boosted growth; instead, they may be creating new asset bubbles,
- in the euro area, monetary policies and the exchange rate have contributed to a favorable financial environment whereas fiscal policies are still restrictive,
- stocks are mostly expensive but are nevertheless the assets of choice,
- the riskiest stocks are carbon assets and global banks with exposure to commodity producers,
- safe-haven bonds are no longer safe at present yield levels; "anyone who feels compelled to buy negatively-yielding bonds is adding risk, not taking it away"; relative yields of euro-denominated corporate bonds will decline further after the ECB has announced that they are now eligible for its bond-buying program.

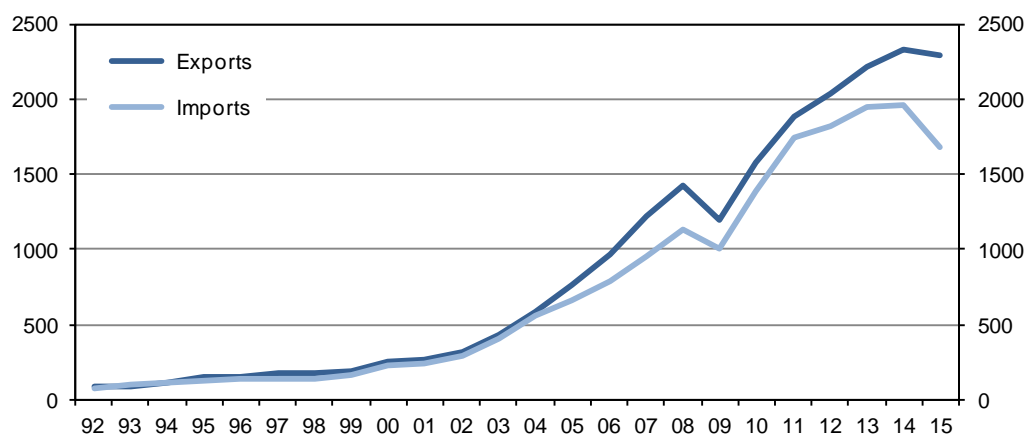
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Why China's economy matters

- For at least one decade, the **main driver of the world economy**, commodity markets in particular, has been China. Its nominal GDP was \$10.8tr last year, compared to the euro area's \$11.5tr and the United States' \$17.9tr. At IMF purchasing power parities (PPP), it is already the biggest economy. Its recent slowdown has a major impact on the rest of the world.
- On the basis of an extremely high saving rate and, whenever necessary, strong doses of anti-cyclical monetary and fiscal measures, its real **GDP used to expand at fairly steady rates of almost 10 percent for a 15-year period which ended in 2011. This has led to overinvestment**, ie, idle capacities in sectors such as infrastructure, property and exports, followed by financial problems and a change in strategy: the government now promotes domestic demand, especially private consumption and services. Growth rates have fallen to about 6 percent this year. This looks like the new "normal".

China - exports and imports of goods

bn US dollar



source: OECD

- Chinese import needs have declined correspondingly – inventories turned out to be too large given the slowdown of growth. Goods imports were down 14.3 percent between 2014 and 2015, or by no less than \$280bn. Since exports held up well, the restrictive effect on other countries and commodity markets has been massive. **The Chinese themselves are afraid that their country is no longer such a good place to invest: capital is fleeing.** One piece of evidence is the \$800bn decline of foreign reserves over the past 21 months, another is the sudden jump of imports from Hong Kong (+ 80 percent y/y in the first two months of the year) which suggests that invoices are artificially blown up as a means to move money to a safe place outside.
- A question that is not easy to answer is whether China has entered a dangerous deleveraging process.** Its private sector debt has exploded in recent years and is now almost on par with Japan's debt immediately before its equity and property bubbles burst in the early nineties. The latest figures are for the third quarter of 2015: they show that debt continues to rise.

6. While the largest debtors are the SOEs, the state-owned enterprises, the main creditors are large banks, also state-owned. **On a net basis, debt is therefore much less than the headline number** and is thus not as scary as it looks at first glance. In other words, deleveraging, with its negative implications for final demand and economic growth, may not do as much damage as in Japan. Household debt, however, has also increased steeply and may be a serious problem by now as stock markets and property prices have fallen a lot. Many consumers must be financially under water at this point and have to cut back on spending.

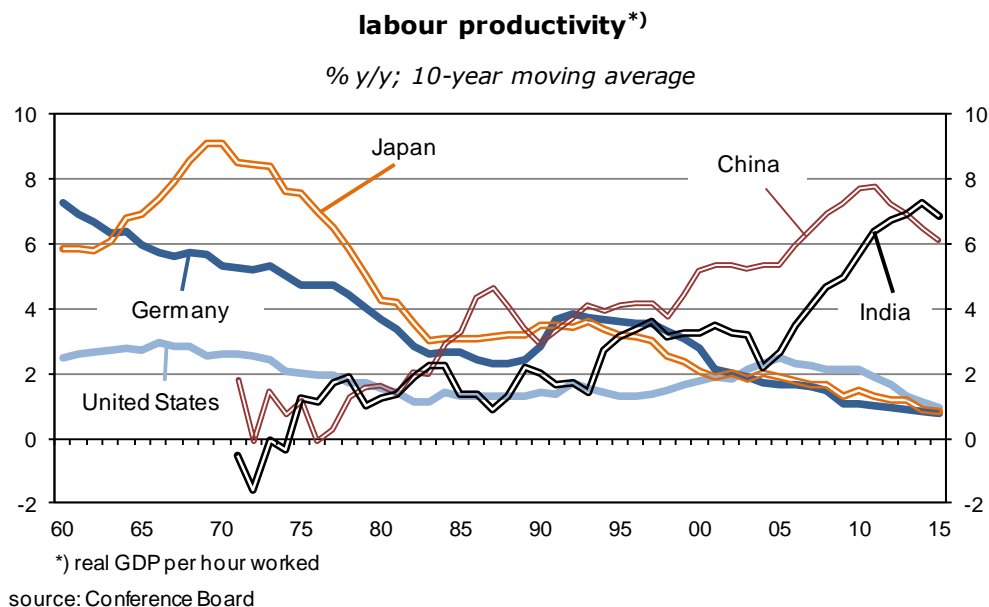
Global growth still robust

7. China is the big unknown of the world economy, and the risks are clearly to the downside. So far, its problems have not thrown the rest of the world off track. **Global real GDP growth this year is now expected to be 3.1 percent. It is not only one percentage point less than in the decade before the financial crisis, it also seems to decelerate.** But considering the many crises that dominate the daily news, a growth rate of more than 3 percent is surprisingly robust and reassuring for investors in real assets. Refugees and doubts about the future of the EU, wars in the Near East and Ukraine, Brexit, the never-ending Greek crisis, China's transition problems, rising policy rates in the US, debt problems in commodity producing countries, a shaky international banking system – the list of risks is long, yet for the world economy these risks are essentially background noise.
8. **Advanced countries will probably expand at a rate of 1.6 percent this year while emerging countries - which now account for 55.6 percent of global output (on a PPP basis) - can expect a growth rate of 4.2 percent – their catching-up processes are well-entrenched.**
9. **By importing and applying state-of-the-art technologies and business models, these countries achieve high rates of productivity growth. These could often be much higher if their institutional framework would be state-of-the-art as well.** Important institutional factors are the rule of law, the protection of property rights, a well-qualified labor force, anti-trust policies, free media, a viable opposition to government, low incidence of corruption, decentralized political decision making, a fair distribution of income and wealth, or the infrastructure. If countries are lacking in this regard, they will be unable to make the transition to high living standards and are stuck in the so-called middle-income trap. To adapt modern technology gets them only so far.
10. Investors should focus on countries which are credibly moving forward on their institutions. For all their problems, **central and eastern European EU members are the most plausible candidates** in this respect.

The productivity puzzle

11. **The slow-down of trend productivity growth to 1 percent and less is presently a big issue in OECD countries, and for financial investors as well.** Productivity determines real interest rates more than anything else. In the US these days, real GDP growth (2.0 percent y/y expected in 2016) originates almost exclusively from rapidly expanding labor input (also around 2 percent), not from more efficient production. Where are the effects of Silicon Valley, the world's innovation hub? It is not much better in the euro area: real GDP growth is

expected to be 1.4 percent in 2016 while employment will probably increase by 1.2 percent. It is somewhat better in Japan, with GDP growth forecast to be 0.4 percent and employment stagnating. In the rich part of the world, economic dynamism has disappeared, at least for now.



12. Productivity may have slowed for several reasons.

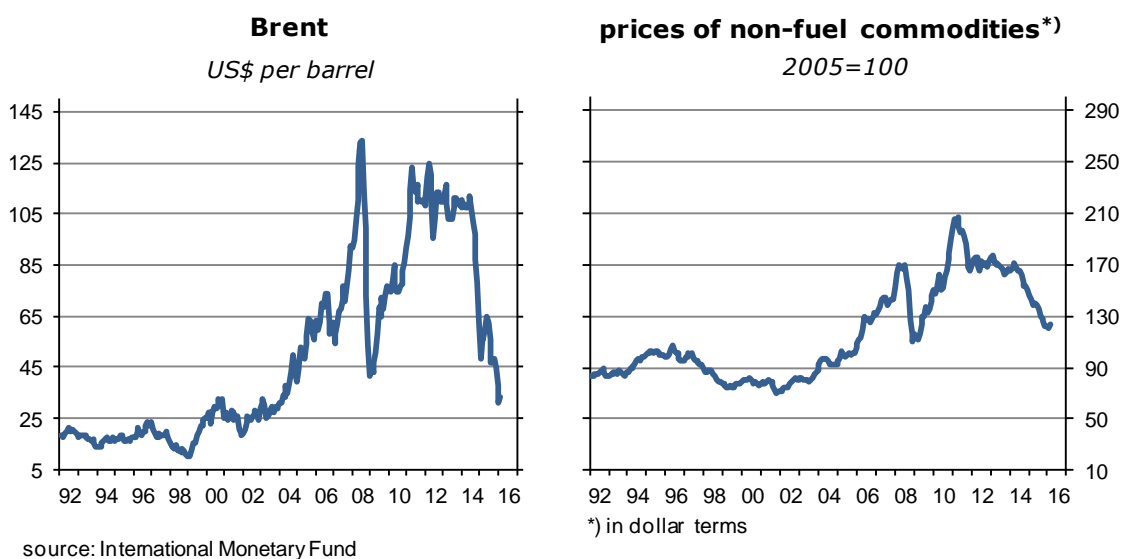
- Since rich countries have a large capital stock, the growth contribution of additional capital spending tends to decline over time – this is the **law of diminishing returns**.
- The **amount of money spent for investment is also down**, or does not increase much anymore, as the number of profitable projects shrinks. Small and large firms alike are increasingly able to move production to other, less developed countries where returns on investment are more attractive; cheap transportation and communication have made the world a transparent place and it is not such a big deal any longer to go multinational, even for small and mid-sized firms.
- The **share of services in total output continues to rise**. In spite of all the progress in online retail trade, telecommunication, air travel, shipping or information gathering, there are large parts of the services sector where productivity gains are hard to come by: think education, health care and other personal services, restaurants, hotels, media, public transport and so on. In manufacturing, the level of output per hour is higher than in services – a structural shift from one to the other therefore reduces average productivity and/or slows its growth.
- Finally, the **relative price of labor has been falling which has reduced the incentive to increase the capital intensity of production**; while wages are negatively affected by slow productivity growth, low wage inflation (in a reversal of causality) is at least partly responsible for the near-stagnation of productivity. Expensive labor forces business to produce as efficiently as possible. In this regard, it is comparable to an overvalued exchange rate. Take Switzerland: wages there are about twice as high as in Germany (or the US), the franc continues to appreciate in real terms, yet productivity is so high that

unemployment is just 3.4 percent. To stretch the point: to boost productivity and thus secure future living standards in ageing societies it is necessary to promote wage inflation.

13. It must be said, though, that **there have been concerns about “secular stagnation” before**. The decline of the West has been a popular topic for at least one hundred years. These predictions were quickly forgotten once economic growth picked up again, as after the end of the Great Depression or the Second World War. For financial investors at this point, the strategy must be to focus on emerging markets where productivity is rising fast, or on firms which are doing well in those regions.

Commodity prices are back to normal

14. Commodities, including hydrocarbons, are no longer a safe bet. There had been much hype about limited reserves, or a concept like “peak oil”, and ever-rising demand. Since China is trying to get away from its long-time focus on manufacturing, the main source of additional demand has dried up. **Commodity prices have fallen to levels which are roughly in line with longer-term trends and are unlikely to develop new bubbles**. Resource efficiency continues to improve, recycling leads to additional supply, alternative energy is on the brink of becoming competitive vis-à-vis oil, gas and coal. Moreover, the global shift to services also translates into lower growth rates of demand for commodities.



15. The decline of the oil price from about \$110 before the summer of 2014 to about \$40 now has led to a **massive redistribution of income from producers to consumers**. We are talking about \$2.4tr a year, or 3.3 percent of the world’s nominal GDP of \$73.5tr (IMF forecast for 2016). Add to this that other commodity prices have also collapsed, by an average of roughly 30 percent. In total, commodity producers are probably something like \$3½tr a year worse off compared to the happy times before the summer of 2014 when they were still riding high.
16. **For the consumers of raw materials this has been a shot in the arm**, whereas the producers, most of them in poor countries, have been hit hard: they are forced to cut spending. Much

of their previous investments have to be written down, and the present value of their future revenue streams has collapsed. A large part of their reserves in the ground is now considered to be “stranded”. Their stock prices have tumbled accordingly.

17. **Most countries that rely on commodity exports are now in trouble**, or will soon be once their financial reserves have melted away, especially if they had based their spending on the assumption that prices would stay high. Russia, Brazil, Argentina, Nigeria, Angola, South Africa, Venezuela, Algeria, Kazakhstan, Azerbaijan, Turkmenistan and even some countries around the Persian Gulf come to mind. Their currencies have depreciated considerably, credit ratings have been cut and stock markets have been weak. Not all countries have managed their windfall gains as prudently as Norway.
18. On the other hand, it could be that all the bad news has already been priced in by now. As **commodity markets seem to stabilize, some of these countries’ assets may therefore offer an attractive mix of risk and return**. Investors should not lose sight of the lagged terms-of-trade effects on national income and political stability, though; most of the countries are run by autocrats.

Inflation will stay low

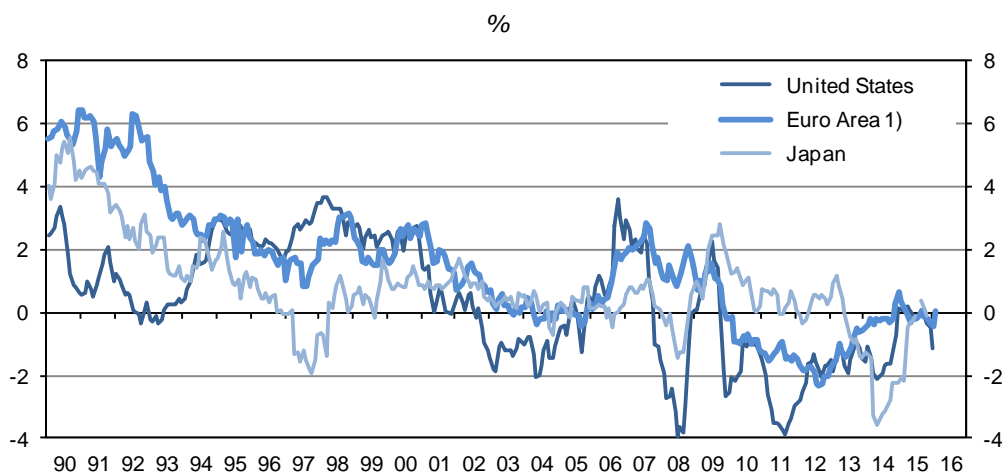
19. None of the previous arguments suggest that global inflation will soon make a comeback. When demand increases by less than potential supply, it is not easy to raise prices or to get larger wage hikes. I guess that on the basis of medium-term real GDP growth rates, the world’s potential supply will be up almost 4 percent in 2016 while demand will rise by only 3.1 percent – **the output gap is thus getting larger, inflation pressures are non-existent**. In addition, depressed commodity prices will keep inflation subdued.
20. **The ECB has just adjusted its forecast for European inflation in 2016 from 1.0 percent a few months ago to just 0.1 percent**. In the US, the Fed has decided to reduce the number of rate hikes this year from originally four to only two, presumably because inflation will stay low – in spite of a booming labor market. The consensus CPI forecast for 2016 is now 1.2 percent (2015 inflation was 0.1 percent). No prizes for correctly predicting whether Japan’s inflation rate will be positive or negative this year: it is expected to be -0.2; moderate deflation continues.
21. **Even in China, still an emerging economy after all, the inflation rate is expected to fall to 1.6 percent** – it had averaged 2.9 percent in the previous six years. Since Chinese productivity will rise by about 4 percent this year, wages and consumer prices could rise by roughly the same rate without causing a loss of competitiveness. The fact that they do not, suggests that disinflation is a well-entrenched global phenomenon and will be with us for some years. Deflation is still not far away, in spite of fairly robust growth.
22. Not only actual inflation rates, **inflation expectations as derived from inflation-protected government bonds are also low, and have been falling**. Over the next five years, market participants believe that consumer price inflation will average 1.5 percent in the US, and 0.55 in Italy. Expected 10-year inflation rates are 1.55 percent for the US, 0.95 percent for France and Germany, and plus (not minus) 0.3 percent for Japan. Investors are quite relaxed about future inflation. Except for the US, central banks will not come close to their inflation

targets of around 2 percent. To be sure, these numbers may be distorted (because the bonds are so scarce), and market consensus is often wide of the mark, but they reflect the views of people who risk their own money.

Central banks aim for negative real money market rates

23. **Inflation is at all-time lows, but why is this also true of real interest rates? At the short end of the European curve, they have been in negative territory for six years** – right now, they are a little below zero, with year-on-year inflation at -0.2 percent and 3-month money at -0.23 percent. For borrowers who need short-term funding, for instance for their inventories or receivables, these are good times. Back in the nineties, and through 2002, real rates had been in a range of plus 6 to plus 2 percent. We live in a very different era now.
24. **The fact that it does not cost anything to raise short-term debt these days reflects the ECB's ultra-accommodative policies.** Low interest rates are the standard tool for stimulating an economy when it operates below its potential. But the transmission channel from real interest rates via bank lending to economic output has been blocked when, in the aftermath of the real estate and banking crises, and the explosion of government debt, priority was suddenly given to debt reduction.

real short-term interest rates*)



*) 3m money market rate minus annual CPI inflation rate - 1) until 1998 Germany

sources: Federal Reserve, Bundesbank, Bank of Japan; own calculations

25. **As the graph shows, things have been similar in the U.S. and, more recently, in Japan.** The bottom line is that short-term liquidity is offered at very favorable terms across the OECD area, but also that potential borrowers are not particularly enthusiastic about adding to their debt. Low real rates reflect both easy monetary policies and a lack of demand for funds. Looking ahead, the ECB as well as the Bank of Japan have repeatedly stated that policy rates will stay very low for a long time, even in case inflation picks up toward, or moves beyond the 2-percent target rates. As to America's Fed, its most likely strategy is to raise the Funds Rate very gradually and keep it below the annual inflation rate for at least one more year – which means negative real policy rates.

26. **On March 10, the ECB cut its rate on banks' excess reserves from -0.3% to -0.4% and thus followed the lead of the Swedish, Danish and Swiss central banks which use even higher penalty rates, while the main refinancing rate was lowered from 0.05% to zero.** The so-called deposit rate has become the policy rate which determines money market rates such as Eonia for overnight money, or 3-month Euribor; they are now -0.35% and -0.24%, respectively. Negative deposit rates (on deposits at the ECB of presently nearly €700bn) mean that banks lose money on these funds. To make up, they will try to raise lending rates which is obviously counterproductive for the economy. Another way out for the banks is to channel the flood of liquidity into stocks, bonds and perhaps real estate, ie, change the risk/return mix.
27. **The ECB has also expanded its monthly bond purchases from €60 to €80bn, or to €960bn a year.** For comparison: according to the EU Commission, in 2016 the aggregated government budget deficit of the 19 euro countries will be 1.9 percent of their GDP, or something like €202bn. Even though those €960bn will now include some high-quality euro-denominated corporate bonds of euro area issuers, most of the money will de facto be used for the monetary financing of government spending, as before.
28. I doubt that the requirement that all purchases have to take place in the secondary market (rather than buying new issues directly from the treasuries) makes much qualitative difference. **The distinction between monetary and fiscal policies has been blurred further – which for me is not bad but something the euro area needs in a situation where the private sector is more than reluctant to borrow and spend.** In January, loans to private households and non-financial corporations were just 1.4 and 0.8 percent higher than one year ago and thus more or less flat.
29. The fact that **corporate bonds are now eligible to be included in the ECB's bond-buying program has turned them into attractive investment alternatives** – spreads vis-à-vis government bonds have begun to decline, and the issuance of corporate bonds has increased dramatically. To overcome the blockade of the transmission channel from the central bank to the real economy it helps to rely more on capital markets and to bypass the banks.

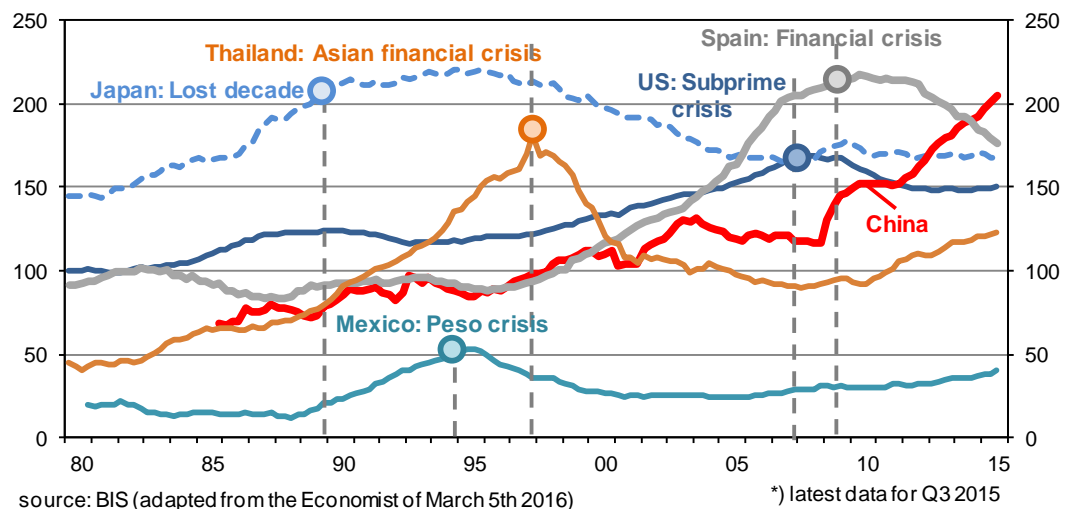
Why deleveraging reduces the effectiveness of monetary policies

30. While monetary policies have been ultra-expansionary before March 10, they are now even more so. And yet, it is less than certain that they will have the desired effects. **Euroland as a whole is stuck in a so-called liquidity trap caused by the 2008 popping of the credit-driven asset price bubbles;** it had left borrowers, including households, banks and governments, with huge debt. Their aim is now get it down to more normal levels which means they are extremely reluctant to pile on new debt. In this sense, monetary policy does not work.
31. **Germany is in a more favorable situation than most other countries of the euro area because there had not been an asset price bubble to speak of** – real interest rates had traditionally been low and thus not an additional incentive to increase borrowing for the purchase of real estate and equities. This is **the reason why easy monetary policies are relatively effective there in terms of GDP growth and employment.** Only the government had seen its debt increase significantly in the early stages of the financial crisis when it had

to come to the rescue of banks with a large exposure to the US subprime market. In the meantime, the debt situation of the public sector is on the mend and has reached 72 percent of GDP; it is rapidly approaching the 60 percent limit of the Maastricht treaty. In terms of fiscal policies, Germany has considerable room for manoeuvre. It is unlikely that it will be used to the full by today's conservative policy makers, but at least restrictive policies are a thing of the past by now.

China at risk - at least at first glance*)

private non-financial sector debt as % of GDP

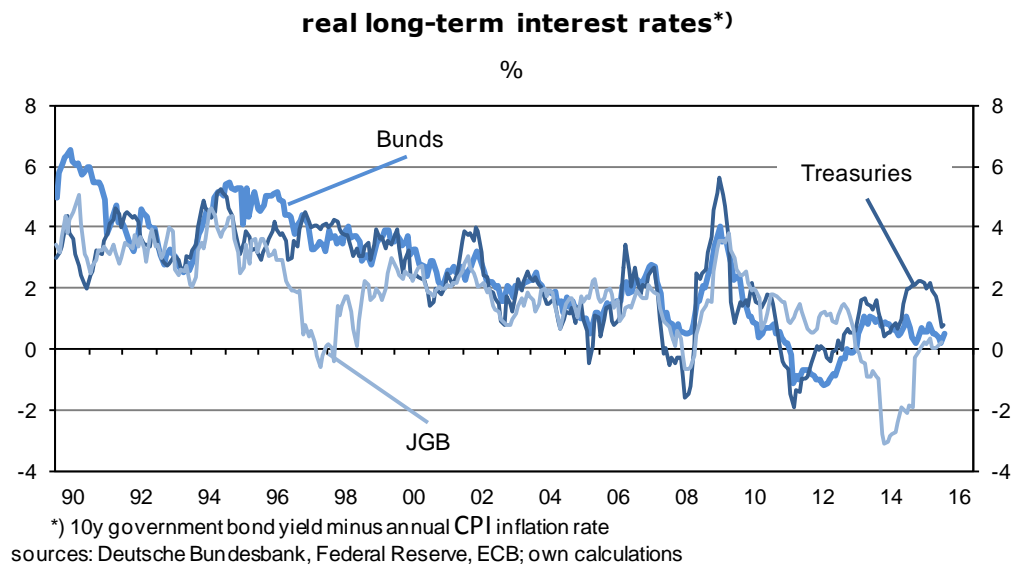


The euro's unfinished business

32. **Real short-term rates** are also very low in the UK, in Japan, in the US, in Switzerland and Sweden. **Especially in the US they have had the desired effect:** one reason is the deleveraging that has taken place in recent years (see the previous graph), the other is the early and massive recapitalization of its banking sector. **That there has been nothing comparable in the euro area points to a serious structural flaw there – the lack of a powerful common Treasury and a bank resolution authority. The ECB lacks a partner who complements its policies on the fiscal and regulatory front.** If the euro is to survive, it sooner or later must be backed up by a fiscal union which can accelerate deleveraging processes and act as a lender of last resort. This is also essential for escaping the various national liquidity traps which hold back economic growth and thus foster anti-euro sentiment across the continent.
33. Incidentally, the UK (outside the euro area) has succeeded to reduce leverage quite considerably and is growing briskly again. Inside the euro area, Spain has also been successful in this regard and has been rewarded handsomely in terms of growth. But **progress for the euro area as a whole has been painfully slow. The same holds for Japan –** the country continues to struggle under its debt mountain a quarter of a century after its property and stock market bubbles had burst. The Abe administration is embarrassed by its huge (gross) debt and does not dare to add to it in a meaningful way.

At the long end of the yield curve, low real rates are here to stay

34. Monetary conditions at the longer end of OECD yield curves are also very favorable for borrowers. **In real terms, long-term interest rates have fallen more or less steadily from about 4% in the early nineties to close to zero.** Home buyers and firms have never before been able to borrow at such low rates. This includes the nineteenth century.



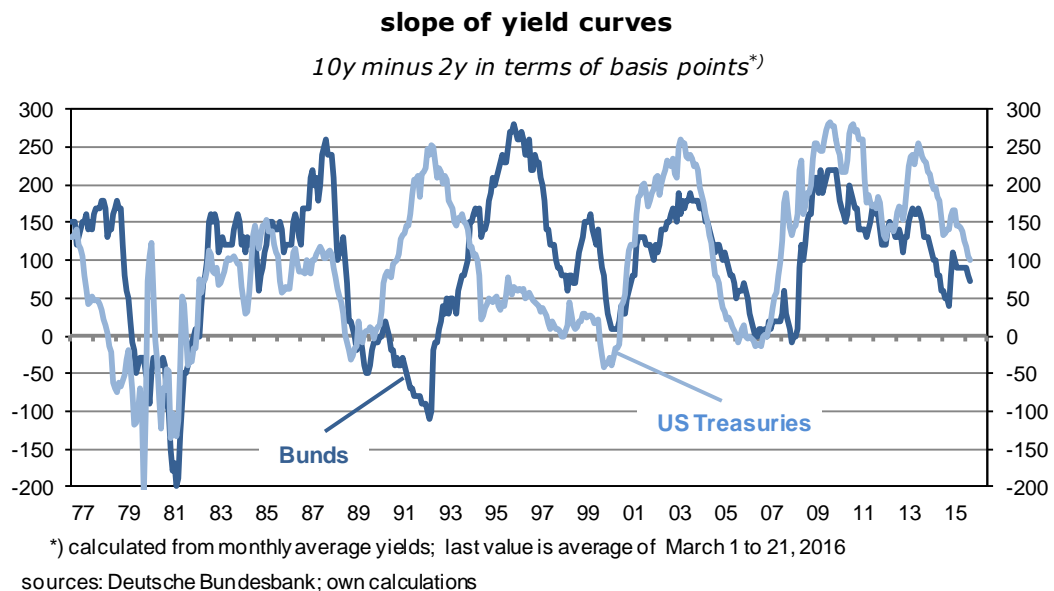
35. Why are they so low? On the supply of funds side, the **aggressive expansion of central bank money and the decline of short-term rates** have forced savers to lengthen the duration of their portfolios, ie, buy higher-yielding assets; this drove down their yields. In addition, the mercantilist growth models of many emerging markets have created a **global saving glut** which reinforced the effects of easy monetary policies in the OECD area. It has helped that expected inflation has steadily declined over the past decades and with it the premium that savers have demanded for holding onto long-term assets. On the demand side, there has been a lack of profitable investment opportunities, reflected in the worrying reduction of productivity growth rates in advanced countries, as described above (paragraph 12).
36. **Emerging markets are not affected because most of them are busy catching up to the living standards and capital intensity in the rich part of the world** – they usually leapfrog various development steps and can thus realize large productivity gains for years on end. Think mobile phones for communication, solar panels for energy or light trucks for transportation, all of them cheap and at the same time able to boost output by several multiples. Over time, their productivity growth will slow as well, but this is still a long time off. Secular stagnation and low real long-term rates are not yet issues for them.

The slope of the yield curve also matters

37. To sum up, low real long-term rates are here to stay because neither the supply nor the demand side are about to change significantly in the foreseeable future. **Another indicator of monetary conditions is the slope of the yield curve.** When central banks want to tighten policies in response to accelerating inflation, they raise short-term rates. The more serious the perceived problem, the more will rates go up, occasionally leading to inverted yield

curves where short-term rates are higher than long-term rates. And vice versa, of course – if the central bank is in easing mode, short-term rates will fall faster than rates at the long end.

38. In the following graph, the basis point difference between 10 and 2-year government bond yields reflects the slope of the yield curve. In a “normal” situation, long rates are about 100 basis points higher than short rates.

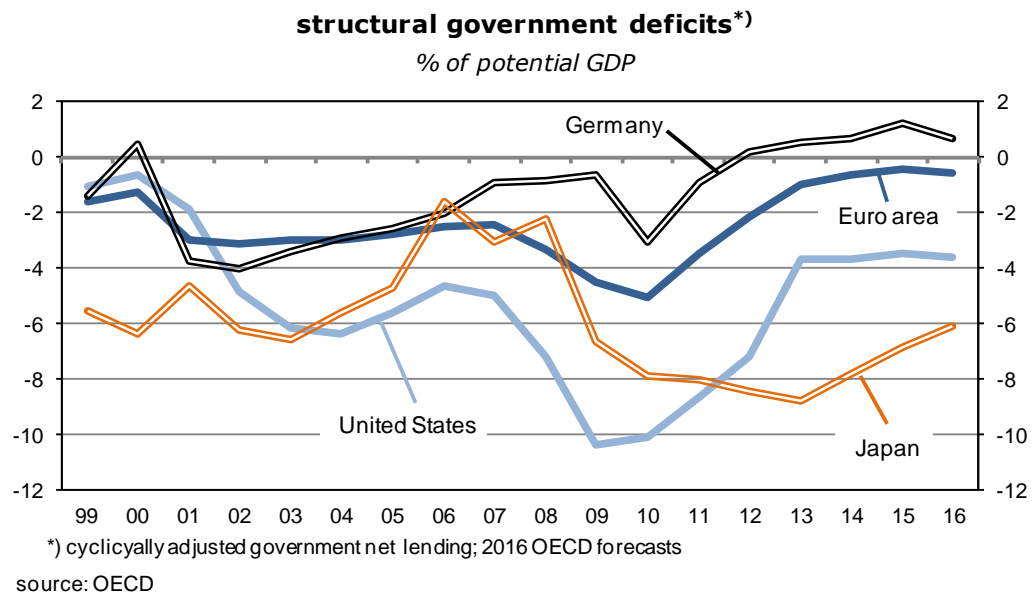


39. The slope increased rapidly and steeply during the recession of 2008/09 as central banks pulled all stops to stabilize the banks and get the economy going again. Since about the fall of 2009, the slope of the yield curve metric is on the way down, both in the US and in the euro area (Germany as a proxy), an indication that monetary policies are getting less easy. **Banks find maturity transformation – borrowing short, lending long – not so attractive anymore which is one of the reasons why they are not so eager provide long-term fixed-rate debt.** Since the ECB cannot cut policy rates much more while some long-term rates could follow the Swiss and Japanese leads and turn negative, the European curve will flatten further. The same will happen in the US, but there the reason is the relatively fast increase of short yields compared to long yields. In other words, monetary policies on both sides of the Atlantic will not be quite as easy as suggested by the levels of real short and long-term rates.

Europe's ineffective fiscal policies

40. How about fiscal policies? What can be expected, and what will this mean for asset prices? For analytical purposes, government deficits can usefully be split into **two parts, a cyclical component which is sort of god-given, and a so-called structural component which reflects the policy stance of the country.**
41. The graph (next page) – which uses OECD calculations - shows several things. Even before the financial crisis of 2008/2009, governments pursued expansionary fiscal policies, ie, ran structural deficits. The rare and brief exception was Germany in 2000. **Recessions after the turn of the century were everywhere fought by fiscal means,** in lockstep with expansionary

monetary policies, followed by not particularly ambitious attempts to reduce the non-cyclical parts of the deficits.



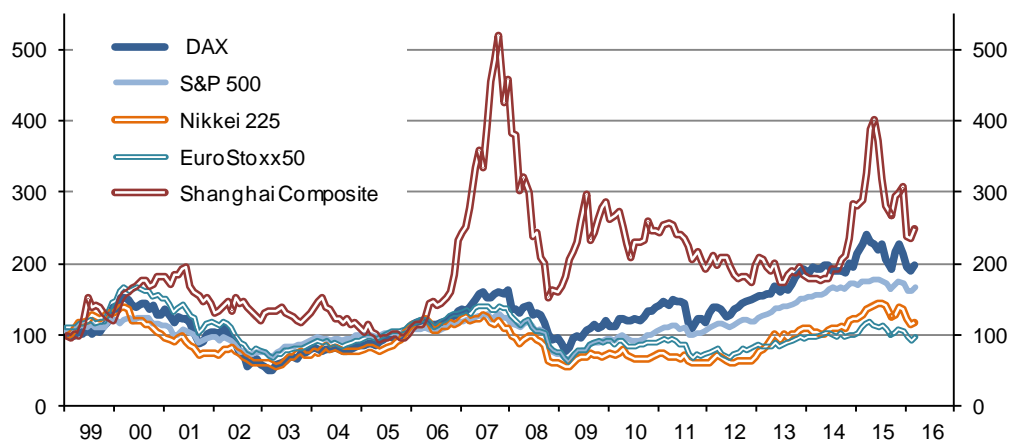
42. **For the US, structural deficits continued to increase all the way through 2004** when they reached no less than 6 percent of potential GDP; after two years of “consolidation” the financial crisis, also called **the Great Recession**, triggered the next escalation of anti-cyclical fiscal policies which drove the structural deficit to more than 10 percent of GDP.
43. In comparison, euro area governments responded only cautiously to the deep recession – at the low point in 2010, the aggregated structural deficit reached 5 percent of potential GDP. **For 2016, the OECD expects a fiscal stimulus of just 0.5 percent, whereas the US Treasury seems to be happy with one of almost 4 percent.** Japan is an altogether different story.
44. Since 2012, German fiscal policies have been outright restrictive. In their wake, other euro countries felt obliged to tighten their fiscal reins as well. **The constraints of the Maastricht Treaty and the absence of a common European treasury have made fiscal policies an impotent player which in turn is at least partly responsible for slow GDP growth, double-digit unemployment, a weak exchange rate and increasingly outspoken and successful anti-euro parties across the continent.**
45. Even though reforms of the euro’s institutional framework are urgently needed, it does not mean that policy makers feel any pressure to act, they don’t. The notable exception is the ECB. The refugee crisis continues to get all the attention. Anything that smells of attempts to move forward in the direction of an “ever closer union among the peoples of Europe ... in accordance with the principle of subsidiarity” is presently being turned down. **Financial investors should not expect that euro area fiscal policies will become more growth supportive. 2016 will be another year of mediocre growth and missed chances.**

Stock markets are well-supported

46. For both savers and corporates it is **important to know whether equities are cheap or expensive, both in absolute and relative terms**. As a saver, I like stocks with low valuations, as a firm which wants to raise equity for capital expenditures or the repayment of debt it is best if valuations are high. Monetary conditions are typically defined from a borrower's perspective, in this case a firm's. Price-to-earnings ratios, the most popular valuation metrics, are real variables because both the nominator and the denominator of the ratio contain inflation rates which cancel each other out.
47. Are valuations high or low at this point? **On the basis of published earnings, p/e ratios for the US market are historically high (18.2). The same applies to the EuroStoxx50 (21.0)** and the markets of Germany (21.3), Spain (22.5), Italy (42.3), Holland (19.9), Switzerland (22.1), or Japan (19.0) and Australia (23.6). Only very few markets are really cheap: Hong Kong (9.2), Singapore (13.1), Russia (7.7) or Turkey (10.4). Some of them are cheap for a reason.
48. **Analysts at broker firms prefer p/e ratios on the basis of current year earnings because these are usually expected to be better than last year's**. But this optimistic bias makes them less reliable, especially in a year like this when the global economy is cooling. In any case, the ones provided by an information company like Bloomberg are good indicators of the market consensus: the S&P 500 on the basis of 2016 earnings forecasts is still quite high (17.0), though, just as the Nikkei 225 (17.8); among the cheaper ones, the EuroStoxx50 is at 13.8, the DAX at 12.6, CAC40 at 14.6, Madrid at 14.1, Milan at 14.5 and Shanghai at 12.1.

major stock markets

Dec. 1998 = 100

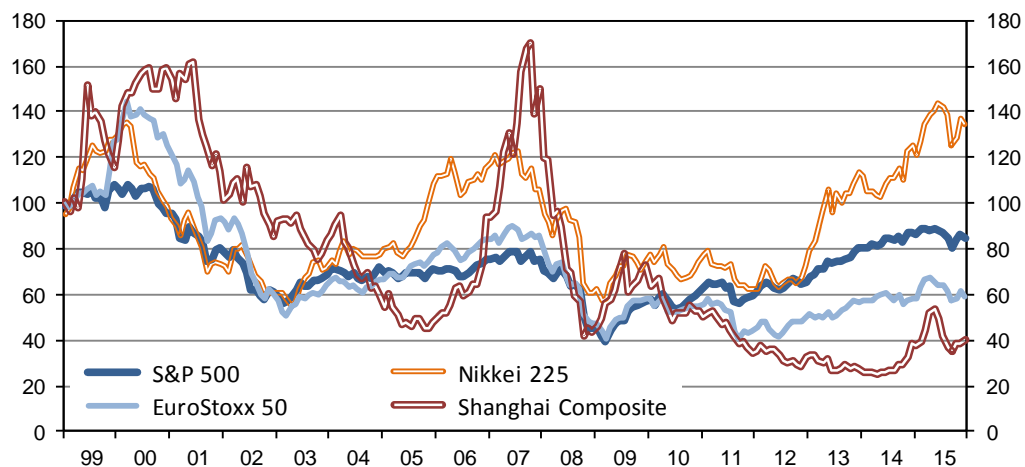


sources: Federal Reserve, ECB, Deutsche Bundesbank

49. Here is another approach: in any country, changes in corporate earnings are usually correlated with the growth rate of nominal GDP. As a first approximation, **if a stock index has increased faster than GDP, it could be a sign that the underlying stocks are too expensive, and vice versa**. By this yardstick, the Japanese market is presently overpriced while the Shanghai Composite and the EuroStoxx50 are relatively cheap. The US is in the middle.

stock markets

performance of stock indices relative to nominal GDP; 1999Q1=100



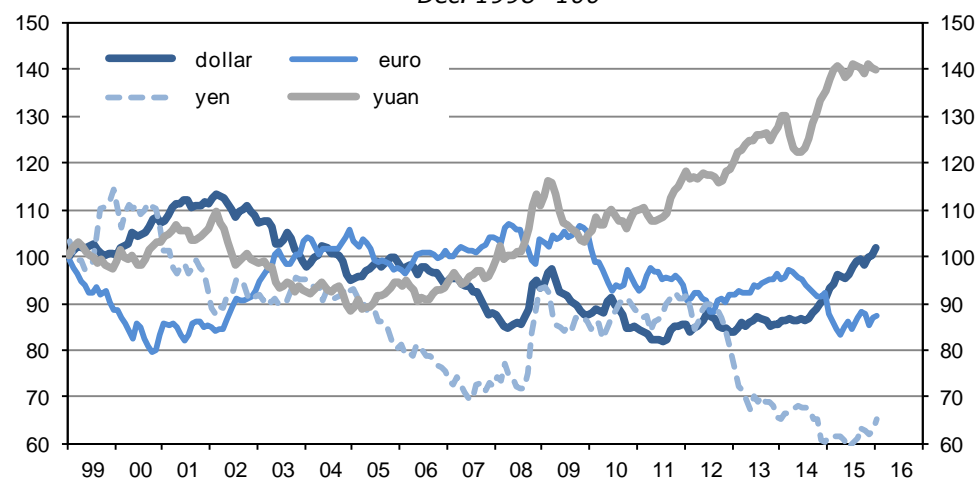
sources: ECB, Eurostat, BEA, NBS; own calculations

50. Overall, for issuers of stocks, monetary conditions in the main markets are thus quite favorable. It does not mean that they will seize the opportunity and raise fresh money for capacity expansion. The cost of finance is just one variable in the decision making process – the more important one is expected sales, together with the rate of capacity utilization. In general, in the OECD area it is still possible to boost output without an expansion of the capital stock. **Neither in the US nor in Europe will stock markets climb to new highs this year. Economic growth is simply too slow, and valuations are mostly too rich. 2016 will be a year of stagnation which is not so bad given that dividend yields provide a nice compensation. Especially in Europe, they are significantly higher than top-quality bond yields.**

Foreign exchange rates need to be taken into account

real exchange rates

Dec. 1998=100



source: Bank for International Settlements

51. For investors who are able and willing to diversify their portfolios internationally, exchange rates cannot be ignored. They can make or break the performance and thus play a key role

- in the allocation process. In spite of the poor showing of the **Chinese yuan** since early 2014, it is **still very expensive in real terms** (where nominal exchange rates are adjusted for inflation differentials). The message is therefore: hands off!
52. The opposite is true in the case of Japan: while stock prices are high in absolute and relative terms, the **yen exchange rate is not. It is almost bombed out** and a candidate for a vigorous rebound. So the strategy could be to invest in conservative Japanese stocks and to leave the FX-position unhedged.
53. **Compared to the euro, the real exchange of the dollar is presently about 10 percent too high. At the same time, both could lose ground against the yen but gain against the yuan.**
54. To be sure, **real exchange rates are but one factor which determines the path of the nominal exchange rate, but an important one.** Balances on current account and interest rate differentials also play a role, just as the relative prices of assets or political developments. All this is well known, of course.
55. That's it. I notice that I am concluding this analysis in a way which is typical for an economist: on the one hand, on the other hand, many factors play a role. But I think I have also taken a stand at several points in the above, and I hope the reader has found it useful after all.

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