



# Wermuth's Investment Outlook

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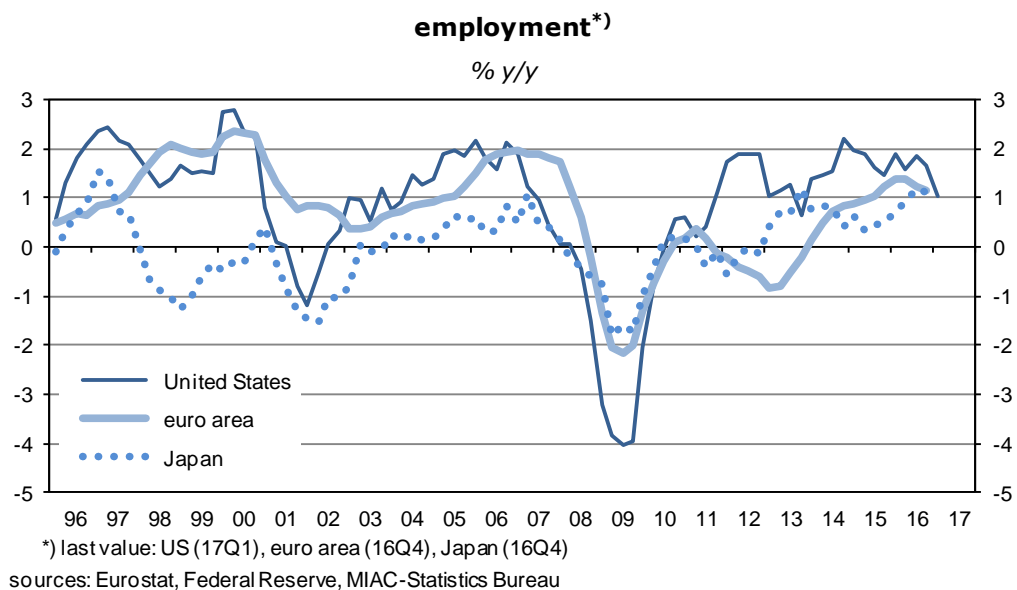
## Sell bonds, don't buy stocks

by Dieter Wermuth\*

1. Since I have become **less convinced about equities** in the foreseeable future, I have changed the headline a little (but decisively) from last time: don't buy stocks.
2. **Bonds of developed market borrowers will decline** as central banks are either tightening or preparing the ground for less expansionary policies. Not much has happened on that front yet, but for me a bond sell-out has only been postponed. It is inevitable.
3. **Stocks are now at risk as well** – their prices have gained between 5 and 10 percent since the beginning of the year (Japan is the major negative outlier) and are no longer cheap. While dividend yields still look attractive, **valuations are stratospheric** and can only be justified if real bond yields remain depressed. This is about to change, so risk premia are set to come down, and stock prices with them.

### headline inflation has begun to rise - slowly

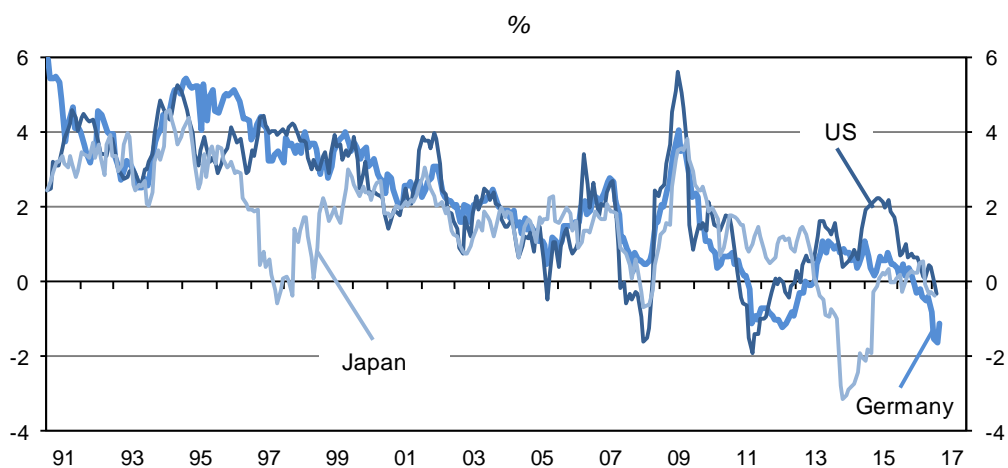
4. **Pipeline inflation is on the rise but the pass-through to consumers remains difficult:** output gaps are still quite large and wage inflation has not yet accelerated much, especially in Europe. Compared to earlier business cycles, wages rise only moderately, presumably because after the shock of 2008/2009 people are more interested in keeping their jobs than to maximize their incomes in response to favorable employment conditions.



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5. I can only speculate that today's labor market cannot be compared to the labor markets of old, given the increasingly uneven income distribution, the rising share of short-term and vulnerable jobs, structural unemployment caused by international competition and reduced regional mobility.
6. In any case, **inflation expectations are still subdued**. Here, the major exception is the UK where market participants bet that 5 and 10-year inflation will be in the order of 3¼% and that sterling will thus depreciate by almost 3 percent annually against the euro. Fairly low British bond yields don't match these expectations which suggests that their spreads over German Bunds need to rise, or those expectations to fall.
7. Next in line is the **United States: future inflation rates are seen to be a little less than 2 percent** which is more or less in synch with longer term Treasury yields; in real terms they are therefore close to zero. Since trend growth of real US GDP is in the order of 2 percent, it is clear that American bonds are also considerably overvalued, provided yields return to some "normal" level in the coming years.
8. **Up to maturities of eight years, German government bond yields are still negative; 10 years are at only 0.24%**. Compared to today's inflation expectations of about 1 percent and medium-term real GDP growth of perhaps 1¼ percent, yields are extraordinarily low. A return to "normal" requires an increase by roughly 250 basis points, the equivalent of a bond price reduction of about 22 percent. In case there is a "taper tantrum", a panic (like 2013 in the US), as all investors want to get out at the same time, losses may well be larger. The ECB is aware of this risk and continues to reassure markets that policy rates will stay where they are for a long time. Does this mean to the end of 2018? It may be wishful thinking.

#### real 10-year government bond yields\*)



\*) 10y government bond yield minus annual CPI inflation rate ; averages for the entire period: US 2.2%, Germany 2.2%, Japan 1.6%

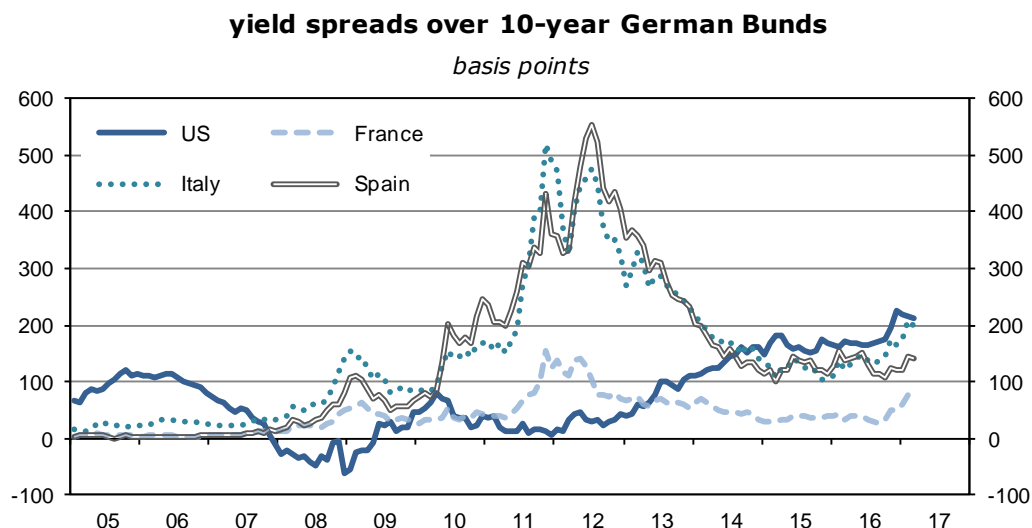
sources: Deutsche Bundesbank, Federal Reserve, ECB; own calculations

9. German bonds are regarded as safe haven assets by investors who are risk averse and are attracted by conservative fiscal policies and a current account surplus in excess of 8 percent of GDP. Put differently, the euro crisis and the skepticism about the future of the euro has been a big boon for the country. **If yields were 100 basis points higher than they actually are, and were thus more like French or Spanish ones, interest expenses would be about €22**

**billion larger this year.** Without this windfall, Germany would not show a surplus in its public sector accounts. There are indications that the government will announce tax cuts worth €15 billion in this election year (Sep. 24) – it can easily afford them and still show a budget surplus. Savers who have aggressively demanded higher interest rates will thus get some compensation for the “hardship” they continue to endure.

### European yield spreads will shrink

10. The question is whether the safe haven advantage will persist, whether the euro will continue to be seen as a risky currency. If not, spreads will decline from today's levels and it **will pay to sell (short) Bunds and buy other euro area bonds**. In the ten year range, spreads, in terms of basis points, are presently the following: Netherlands 24, EFSF 36, Ireland 66, France 66, Spain 136, Italy 198, Portugal 260, Greece 648. As the graph shows, spreads have at times been significantly smaller.



source: ECB; own calculations

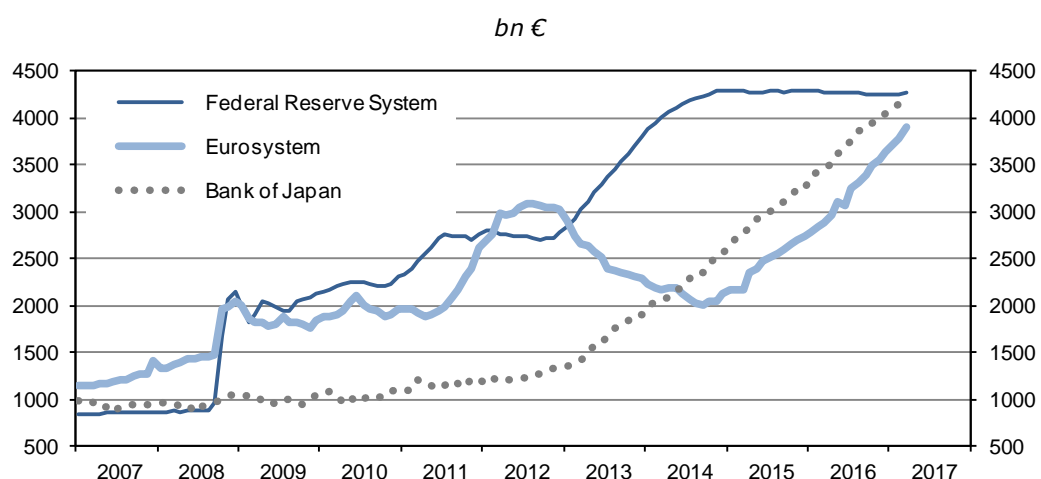
11. **The reallocation of euro area bonds is a low-risk strategy because there is no convincing fundamental reason to speculate against the euro in the coming months:** the combined euro area current account surplus will be about 3.0 percent of GDP this year (US minus 3.0 percent) - only France and Greece have small deficits, all others show surpluses - while the aggregated government budget deficit is expected to be just 1½% of GDP (US -3½ percent). Moreover, economic growth turns out to be stronger than forecast by international organizations such as the IMF and the OECD. The weak euro exchange rate continues to boost demand and therefore growth. There will be no new crisis in Greece this year. Moreover, the Brexit negotiations have the welcome side effect of strengthening EU solidarity. And the ECB will do whatever it takes to support the euro. It has the means.
12. Even if bond yields rise in all euro area countries, a reallocation into supposedly riskier bonds would still be profitable. To make an additional technical point: the so-called duration of German 10-year bonds is longer than that of Spanish, Italian, Portuguese or Greek bonds (which have higher coupons). Losses are larger the longer the duration, for any given increase in yields.

13. How about **Japanese bonds**? The country's "general government gross debt" will remain in the order of 250 percent of GDP. Every market participant is aware of this and yet, 10-year yields are just 0.04% and thus quite a bit lower than those of Bunds. Japan is an even safer haven than Germany. I guess this is mostly because the government can order the Bank of Japan to buy newly issued debt directly and in unlimited amounts. This is actually happening in a way. The German government cannot demand the same from the ECB – the Bundesbank's so-called capital key, its share in ECB equity, is 25.6 percent and thus only a minority. More importantly, central bank members of the Eurosystem are not allowed to purchase government in the primary market.

### central banks pursue different strategies

14. Japanese consumer price inflation has lately been just 0.3 percent which not only means that real yields are higher than in Germany, it is also far below the 2 percent target. Inflation-linked bonds show that markets expect an average inflation rate of 0.44 percent over the next ten years. In other words, **the BoJ will remain very expansionary**. A second target is to keep the nominal 10-year yield at around zero. Just as the ECB, the BoJ relies on a massive quantitative easing program – monthly purchases are in a range of \$70 to \$105 billion, with no end in sight. In spite of rising global bond yields, Japan's will probably not move much and stay very low in nominal terms. **JGBs are a fairly safe bet and a means to diversify risks in bond portfolios.**
15. A key determinant for bond markets is the outlook for monetary policies. When central banks raise rates, the whole money market follows and makes it less attractive to hold bonds; banks in particular are hurt because their standard business model of borrowing short and investing (lending) long becomes less profitable. The selling of bonds will then drive down their prices and push up bond yields and mortgage rates. So **the question for investors in fixed-income assets is what to expect from central banks.**

### central bank balance sheets\*)



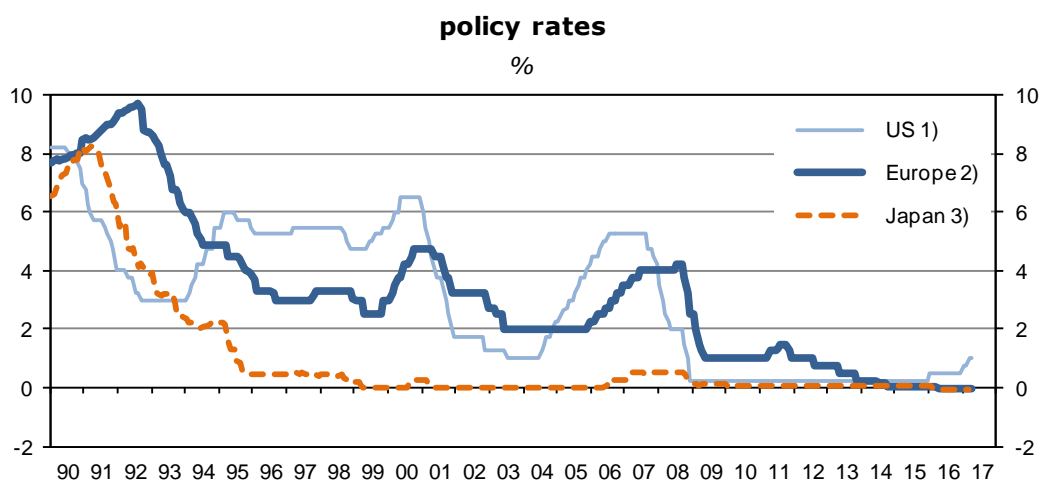
\*) total assets; translated at 1.06\$/€ and 117.7¥/€

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

16. **For the US Fed, the mandate is to achieve full employment and price stability**, the former recently (and opportunistically) defined as a "longer-run normal rate of unemployment" of 4.7 percent, the latter as an annual increase of the price index for personal consumption

expenditures (PCE) of 2 percent. Below 4.7 percent unemployment, inflation is expected to accelerate faster than the acceptable pace of 2 percent – policies should therefore become restrictive and slow down the demand for goods and services.

17. There are two main instruments to achieve this: raise interest rates and withdraw central bank money from the economy. **So far, the Fed has cautiously raised the Funds rate three times in this cycle, but it is still only at 0.75 to 1.00% and thus negative in real terms. In this regard, monetary policies are still rather expansionary.** As to central bank money, it has not changed much since November 2014, but FOMC members have begun to discuss to reduce it by not rolling over maturing Treasury and mortgage assets on the Fed's balance sheet.
18. **By most yardsticks, the US has achieved full employment.** Only 4½ percent of people in the labor force are presently looking for a job, and employment has been increasing at annual rates of 1 to 2 percent for several years now. The main negative statistic is the labor force participation rate - which hovers around 63 percent and is thus well below its 67.3 percent high of 17 years ago.
19. **US policy makers continue to be surprised by the slow increase of wages;** in March, on an hourly basis, they were only 2.7 percent higher than one year ago. This, incidentally, is the same as the latest consumer price inflation rate (CPI). According to Fed meeting minutes, the expected core price index of personal consumption expenditures as well as the non-core price index are just 1.9 percent year-on-year and thus well under control.
20. **In other words, the Fed can justify further rate hikes.** Its so-called dot charts show that there will be two further 25-basis point hikes this year, and three more next year. By the end of 2019, the funds rate is seen to be at 3.00% which is also the rate that is expected to prevail over the long term. Markets see it differently – for them, the trajectory is much flatter. Are they speculating against the Fed? Normally, it does not work. For me, it is pretty certain though that US monetary policies will become increasingly restrictive. Only a significant slow-down of the rate of job creation, ie, a recession can prevent this.

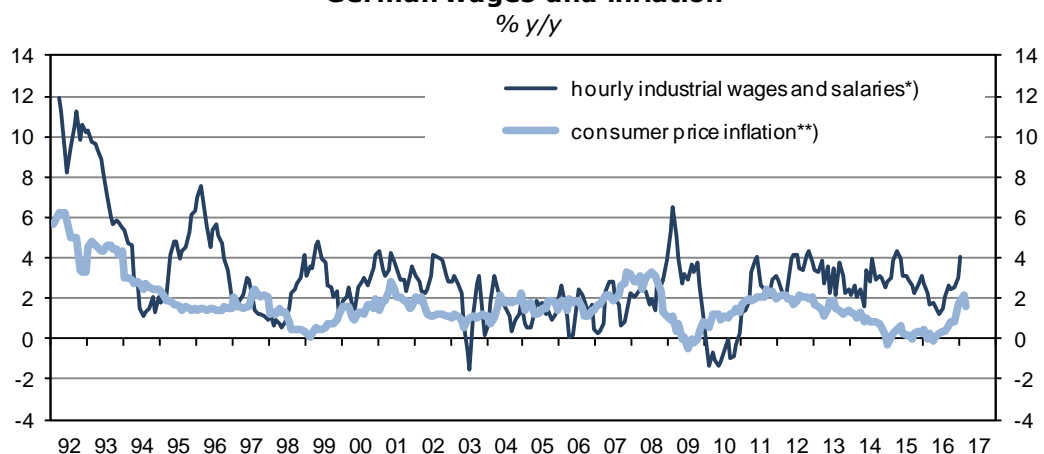


1) Federal Funds Target Rate – 2) until 1998 Wertpapierpersönungssatz of the Bundesbank, since 1999 MRO of the ECB – 3) Overnight Call Rate

sources: Federal Reserve, Bundesbank, ECB, Bank of Japan

21. **The ECB has usually followed the Fed in due course, but not yet this time.** While the Fed is in tightening mode since December 2015, Mario Draghi continues to insist that there won't be any rate increases as far as the eye can see – for him, the main refinancing rate, the ECB's key policy rate, will not change this year and stay at zero percent. By next December the ECB would be behind the Fed by no less than two years. Such a lag happened only once, at Bundesbank times, and implies that the **ECB is still worried about high unemployment and deflation, does not believe that quickly rising pipeline inflation is a genuine threat to price stability at this point, and does not mind a further depreciation of the euro against the dollar.**
22. **It is a policy geared to support borrowers, both private and public. While it is obviously painful for savers, it has done wonders to government budgets,** including Italy and Spain (but not yet Greece), and even to economic growth. All euro area countries will show positive growth rates for real GDP this year. As I have pointed out above, austerity champion Germany is now finally thinking about large tax cuts – others may follow. In retrospect, the ECB's policies were exactly what the patient needed given the negative effects on demand and employment of tight fiscal policies demanded under the Maastricht Treaty.
23. **But the ECB is now closer to a turning point than it will admit.** For one, an even lower euro exchange rate is not adding much to the effects of previous depreciations – the euro has already fallen from \$1.60 in April 2008 to \$1.06 now. Import prices have been rising at double digit rates (10.5 % 6-months annualized in Germany), while industrial producer and export prices are up by about half that rate. In Germany, the continent's bellwether, effective hourly wages in industry have recently increased by no less than 5.2 percent year-on-year while unit labor costs were up 2.9 percent. Wage inflation is finally picking up.

### German wages and inflation



\*) 3-month moving averages; last value: January 2017 – \*\*) last value: March 2017

source: Deutsche Bundesbank

24. **The second reason for a review of present monetary policies in Europe is therefore the return of inflation.** It is not yet certain that the higher numbers are here to stay, but the robust expansion of real GDP together with significant progress on the employment front suggest that the amount of slack in the economy is shrinking – which means it is easier than before to raise prices and wages. One idea that had been discussed recently has been whether the ECB could increase interest rates while continuing its €60 billion-a-month net purchases of government and corporate bonds. Over the next few months it is unlikely that

the issue will come up again as headline inflation in March dropped so much that it will take time to come near the 2 percent target again.

25. What can bond investors take home from all this? It is clear that the Fed will continue to raise rates, if at a slow pace, whereas the ECB is in a rearguard battle to defend its extremely expansionary policy. As to Japan, if it were possible, the BoJ would like to become even more expansionary.
26. **One thing is certain, policy rates in the entire OECD area will not fall anymore, and it is only a matter of time before the ECB follows the Fed's lead. This is bad news for bonds but actually good news for banks, insurance companies and anybody with fixed financial obligations, and of course for savers in general. Don't expect anything dramatic – change comes slowly these days in money and fixed-income markets.**

### expensive equities

27. Stock markets are another story. They have advanced much faster than nominal GDP and per-share earnings. All the money printing has not brought about the lending and capital spending boom central banks had been hoping for. Banks were, and still are, pre-occupied with restoring their financial health, especially their equity ratios. This means they have to raise capital and to eliminate risky and low-yielding assets and are therefore not particularly keen on expanding their loan books. So **a large share of the liquidity generated by central banks went into securities markets. Since bond markets had become increasingly risky, stock markets were the obvious alternative.**
28. They are **supported by the expansion of the world economy.** Even though its recovery from the Great Recession is now almost eight years old, the likelihood of a new recession is small. I am aware that analysts at both small and large institutions have historically been unable to call recessions, and may miss the turning point in the business cycle again, they are probably right this time about 2017 as another year of roughly 3 percent real GDP growth.

### real GDP and inflation around the world

	2015	2016	2017	2018	2015	2016	2017	2018
	real GDP growth (%)				consumer price inflation (%)			
United States	2.6	1.6	2.4	2.8	0.1	1.3	2.4	2.5
Japan	1.2	1.0	1.2	0.8	0.8	-0.1	0.4	0.6
euro area	2.0	1.7	1.6	1.6	0.0	0.2	1.7	1.6
Germany	1.7	1.9	1.8	1.7	0.1	0.4	1.9	1.5
Eastern Europe	-0.5	1.1	2.1	2.2	2.9	3.1	4.2	4.2
Latin America	-0.8	-1.0	1.2	2.7	5.5	5.8	4.2	3.8
OPEC	2.6	1.7	2.6	3.8	–	–	–	–
China	6.9	6.7	6.5	6.3	1.5	2.1	2.2	2.9
India	7.6	7.0	7.3	7.7	4.9	5.2	5.2	4.6
world	3.1	3.0	3.3	3.6	2.8	2.9	3.3	3.3

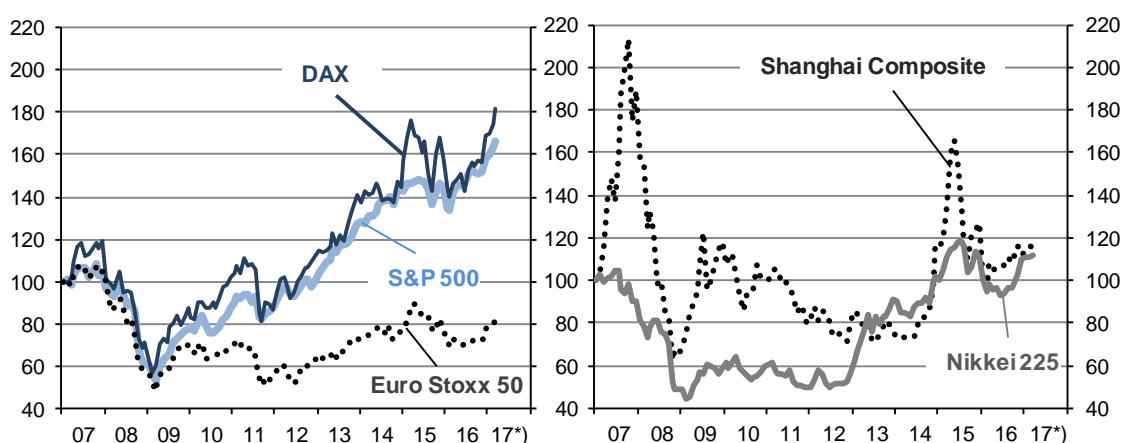
sources: OECD, IMF, EU Commission, ECB, Intesa Sanpaolo



29. **The most dynamic region is, as usual, emerging Asia**, especially China and India. China's growth is slowing, but India continues to gain momentum. Together with neighboring countries they account for about 40 percent of the world's population and are leapfrogging to overtake the OECD countries in terms of purchasing power. Companies that succeed in international markets will experience strong growth of revenues and profits, no matter where they are based.
30. In terms of **sector allocation, financial firms** are likely to rebound from their long slump as the improvement of their balance sheets and the coming normalization of interest rates makes more lending both possible and attractive.
31. Extreme competition, caused by the ongoing integration of global markets, transparent pricing policies and falling transportation costs will continue to exert pressure on established **airlines, shipping companies, stationary retailers and local monopolists in general**.
32. Attempts, like in the US, to restrict international trade and migration will only be temporarily successful as the main effects of new walls are to preserve sclerotic structures and to reduce international competitiveness (and thus productivity and income). Investors should also keep an eye on the revolution that takes place in the energy sector.
33. Aside from the ongoing need to adjust the allocation of equities in response to secular changes in economies it is necessary to ask whether their prices are broadly in line with those of **potential substitutes such as bonds, cash, equities of firms in emerging countries, real estate, commodities and foreign exchange**. As mentioned above, equities are no longer cheap. Their prices have been driven by a lack of good alternatives and are therefore bound to decline when the situation normalizes in terms of short-term rates and bond yields.

#### major stock indices

Jan. 2007 = 100



\*) last value: March 2017

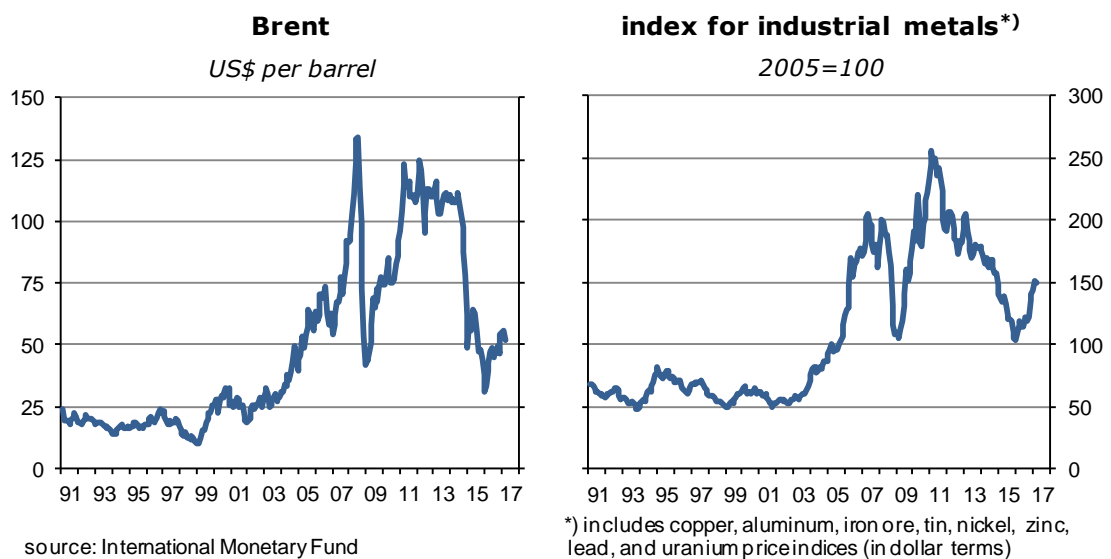
sources: ECB, Deutsche Bundesbank, Handelsblatt; own calculations

34. **Most price-to-earnings ratios on the basis of estimated current year earnings can only be justified if the implied growth rates do indeed materialize. But we are already at a late stage of the business cycle where growth tends to slow.** Here are today's p/e ratios for the main stock markets: S&P 500 18.2, Euro Stoxx 50 14.9, FTSE 100 14.8, DAX 13.8, CAC 40 15.1,

Nikkei 16.5 and Shanghai 13.9. In each case, forecasts imply a significant increase of profits from last year, from plus 160 percent in the UK, via about plus 30 to 40 in Germany, Spain and the two Asian markets, to about 20 percent in the US and France. Neither the level of today's p/e ratios nor the predicted improvement in per-share earnings are sustainable and realistic. Stock prices must therefore correct. They typically do when central banks change course, as today. In addition, when stocks are valued on the basis of cyclically adjusted earnings along the lines of Yale's Robert Shiller, they are even more expensive than on the basis of traditional short-term approaches used by brokers. Leveraged stock purchases are as dangerous as ever at today's price levels.

### hardly any upside potential for oil and metals

35. Are commodities an alternative? The steady if moderate expansion of the world economy and its epicenter in Asia suggest that commodity and energy intensive goods production plays a large role in the coming years. The new middle class wants to – and will - catch up with western living standards in terms of housing, mobility and infrastructure which provides a **robust fundamental support for commodity prices**. **Rising interest rates have the opposite effect.**

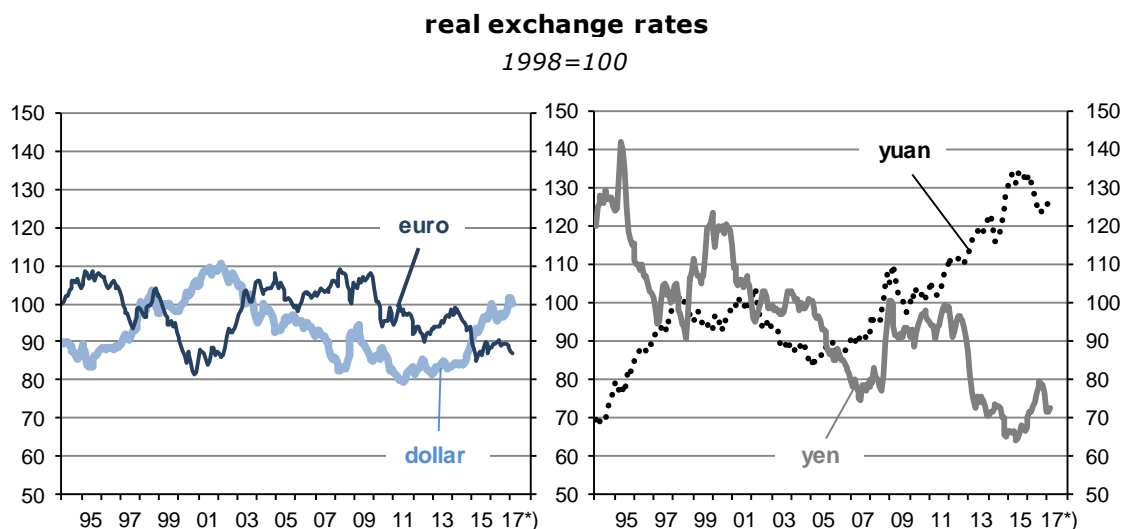


36. In the introduction to its new Energy Outlook, BP writes that **“rising prosperity drives an increase in global energy demand**, although the extent of this growth is substantially offset by rapid gains in energy efficiency: energy demand increases by only 30%” over the next 20 years, ie, by an annual average of 1.3 percent. “Oil demand grows throughout the Outlook, but the pace of demand slows with non-combusted use replacing transport as the main source of demand growth.” “The increasing penetration of electric cars and the broader mobility revolution will have an important bearing on future oil demand.”
37. Oil production continues to grow (at 0.7% p.a.) although its pace of growth is expected to slow gradually. On the other hand, there are **abundant oil resources**. Over the past 35 years, “for every barrel of oil consumed more than two new barrels have been discovered.” The oil price has been holding up at above \$50 for a while now – longer-term, it is bound to decline.

38. **Metals provide a mixed picture:** just to mention the obvious, steel prices are under pressure from excess capacities, especially in China, but copper, silicon and lithium profit from the rapid expansion of alternative energy and the equally rapid shift toward electric vehicles. Each category of metals must be analyzed separately because of the many diverse factors that work on the demand and supply sides. Food prices are caught between a slowing growth rate of the world's population (to 0.9% p.a.), rising demand for meat and fish, and large productivity gains (frequently at the expense of quality). It is not a growth industry.

### exchange rates: let's bet on mean reversal

39. If one looks at the following graph, the first and also the main impression is that **exchange rates have probably moved far away from equilibrium levels**, however defined. In the long term, real exchange rates, ie, trade-weighted and inflation-adjusted nominal exchange rates, should move sideways, as improvements in competitiveness – reflected in a falling rate – should boost demand for the currency and thus drive up its price again, and vice versa. In the case of China and Japan this way of thinking has obviously not been useful: the one currency seems to be on a secular uptrend, the other on a downtrend, with large swings around those trends. Since the end of 1993, the real yuan has gained no less than 80 percent, while Japan's yen has lost 40 percent (note that you may gain well above 100 percent on the way up, but never lose more than 100 percent on the way down).



\*) last value: February 2017

source: Bank for International Settlements; own calculations

40. I guess that **the real appreciation of the yuan is untenable in the longer term**. While China's current account surplus is still large (1.7 percent of GDP), its high saving rate and the slowdown of infrastructure spending produce large and perhaps rising net capital outflows which bring down the exchange. This is happening already. In this regard China resembles increasingly Japan where structural surplus savings of an ageing society force capital out of the country and into markets with higher marginal returns on capital. But Japan has a larger current account surplus (3 percent of GDP) than China and is also, as I mentioned above, a safe haven for risk-averse investors. In other words, **the real yen will appreciate over the medium term**.

41. **Dollar and Deutsche Mark/euro have something like a symbiotic relationship.** The fluctuations around a stable horizontal trend suggest that the mechanism of mean reversal is reliably at work. At this point, the real dollar is up 25 percent from its last low in 2012 whereas the euro has lost 20 percent since the last high in 2009. A correction of that discrepancy is overdue, given the superior European fundamentals (except for the growth differential and real policy rates). It will not happen near term because, as I said, the ECB does everything to maintain zero interest rates and a weak exchange rate. Longer term, fundamentals will always prevail.

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