WEBLOG

Wermuth's
Investment Outlook

June 2017

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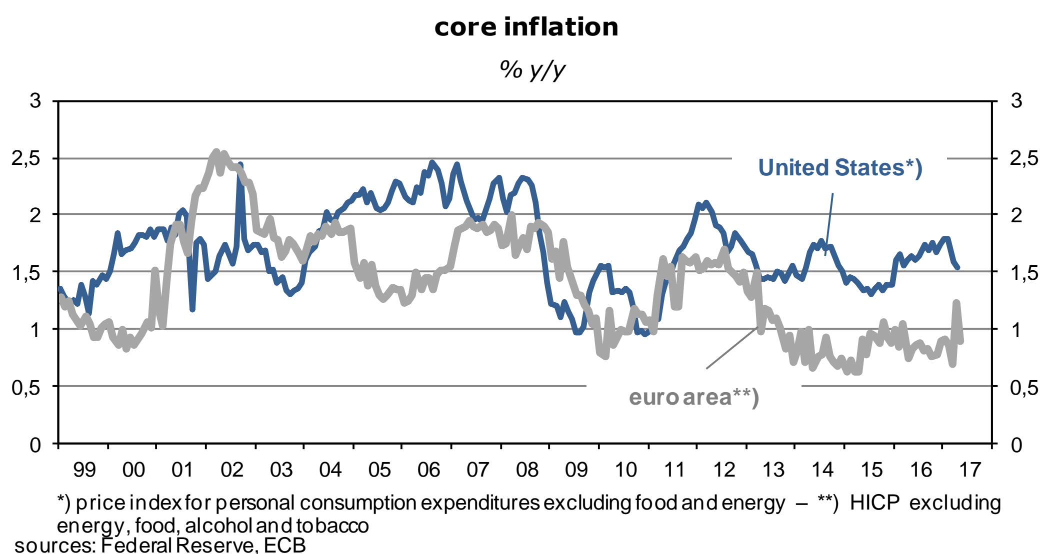
Deceptively calm markets

by Dieter Wermuth[*]

1. Markets are presently characterized by an **unusual degree of complacency and optimism**: the volatility of bond and stock prices is very low, central banks intend to stick to their very accommodative policies, including the Fed, government bond markets across the OECD area have been firm for several months, and stock indices continue to march to ever higher levels and valuations. The bond selloff that had begun almost one year ago in the euro area and the United States came to a halt in late January as inflation, core inflation in particular, remained surprisingly subdued. No sense of panic there.



Why wage inflation remains subdued

2. **In spite of improving labor markets (in the euro area) and near-full employment (in the U.S.), wages have not responded in the usual way – they are increasing very slowly and not yet a risk to price stability.** Indeed, if they do not pick up significantly, they may have deflationary effects should productivity growth in the OECD area recover one day. Wages are the main driver of consumer price inflation and deflation.

[*] Dieter Wermuth is a partner with Wermuth Asset Management GmbH and regularly contributes texts to the HERDENTRIEB weblog which is available on the ZEIT online website.

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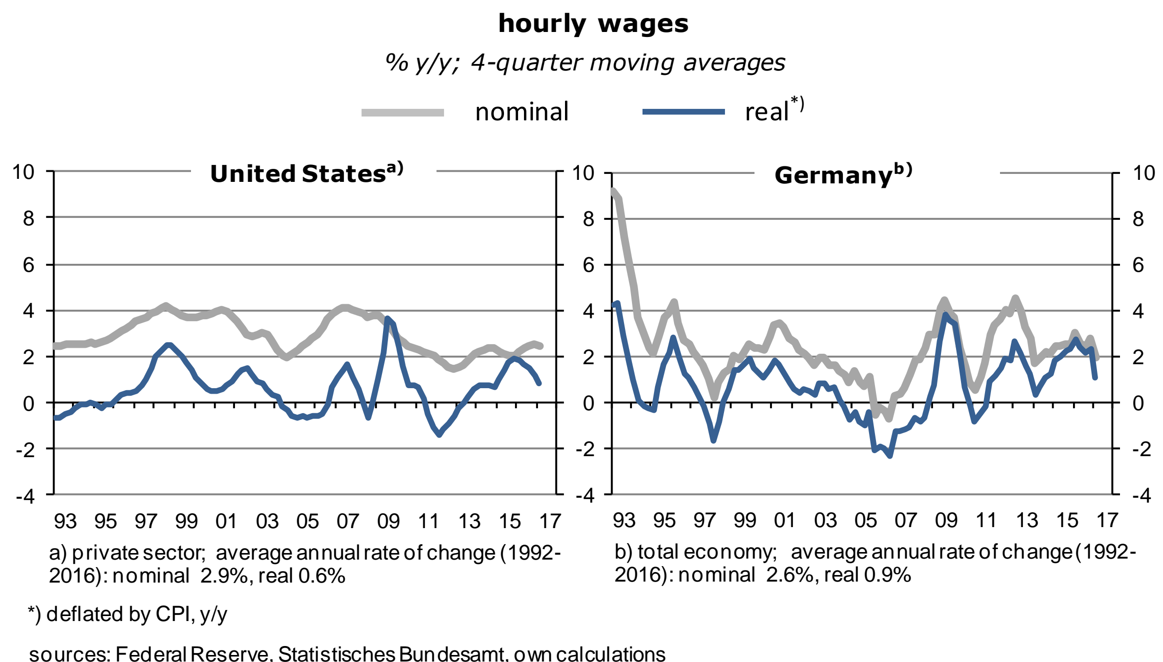
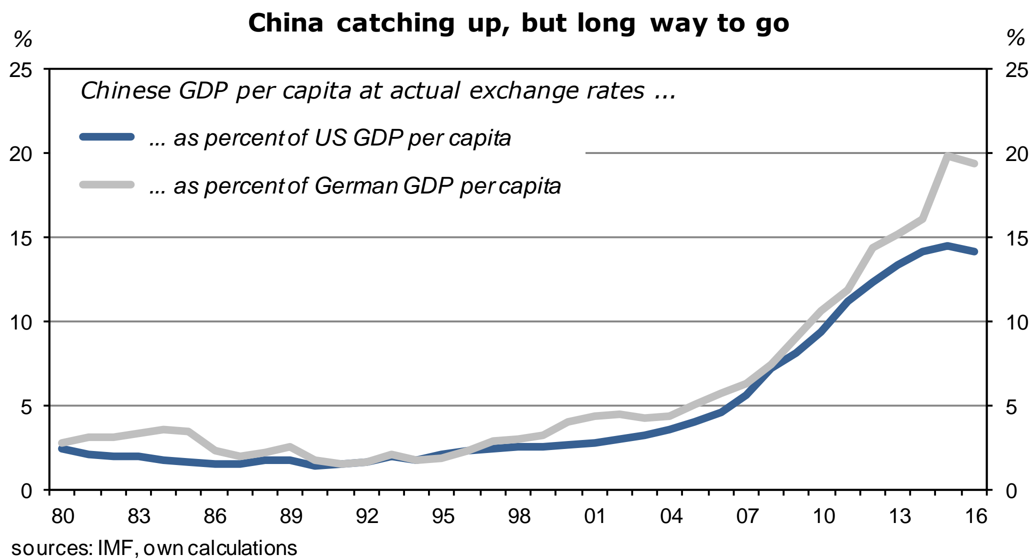


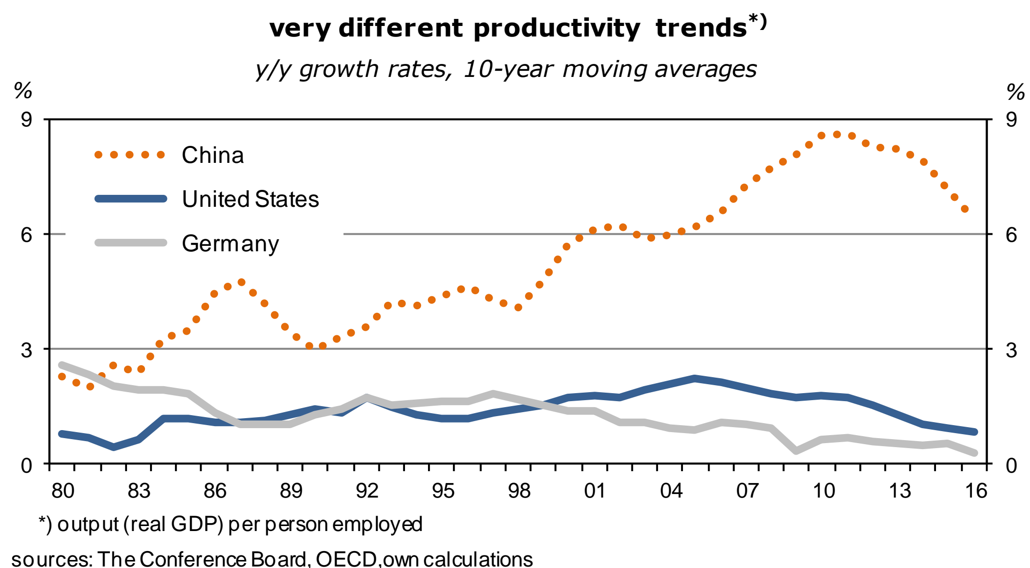
3. **For investors, a key question is whether wage inflation will remain subdued. If the answer is yes, they can continue to bet on extremely low policy rates and well-supported bond markets.** It would also mean that the income distribution will move further in the direction of capital owners and thus provide additional empirical support to the validity of the now-famous formula of French economist Thomas Piketty – that r > g, where "r" is the return on investment and "g" the trend rate of real GDP growth. Output and thus overall income rise at a rate of g, but the owners of capital see their income, ie profits, rise at a faster rate. This would also provide support for stock markets. The long-term implications for long-term social stability are negative, though – but the state has the fiscal means to correct those imbalances. The awareness that there may be a problem is increasing only slowly.

4. **Two main reasons are suggested to explain the phenomenon of low wage inflation: international trade and the seemingly secular decline of productivity growth in industrial countries.**

5. In a world of open borders, near-perfect transparency of global markets – thanks to the internet –, the ongoing shift from the production of goods to the supply of services, as well as steadily declining costs of transportation, **national labor markets are increasingly integrated into a global labor market.** The worker in Munich competes directly with his colleague in Shenzhen. It matters that Chinese wages are only about one fifth as high as in Germany. The "modest" Chinese worker puts a limit on what sort of wage hike the German worker can expect. In the following graph, I have used nominal GDP per person as a proxy for wages.



6. As long as the difference is so large, wage inflation in OECD countries can hardly accelerate significantly. The other argument revolves around the **concept of "secular stagnation" of productivity**. In the long run, wages are determined by the productivity of workers which in turn depends on their professional qualification and the capital intensity of production. Whether we are indeed faced with a "secular" trend is a hotly debated topic among economists, but the data is unambiguous: as the next graph shows, German productivity growth has been on a downtrend for two decades, and for 12 years in the U.S.



7. It is not a foregone conclusion that productivity growth will stay forever low – what about the effects of the digital revolution? –, but so far there are no indications of a new acceleration and thus faster wage growth. There are some robust sectors such as German industry and construction where wages have begun to rise briskly, but on average this is not the case.

Easy monetary policies to continue

8. Both the ECB and the Fed are therefore expected to maintain their easy policies. ECB president Mario Draghi has excluded higher policy rates for at least another year. As to the Fed funds rate, while it has been raised twice this year, it is still in negative territory in real terms and will probably remain there, going by the expectations of market participants: for market participants, the odds of another hike in September are presently only about 50/50, not only because of low wage and core consumer price inflation, but also because employment growth has visibly slowed in recent months. The Fed, on the other hand, has said on June 14 "that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate." As an additional step towards tighter monetary conditions, the Fed "currently expects to begin implementing a balance sheet normalization program this year, provided the economy evolves broadly as anticipated." In other words, it intends to begin shrinking its balance sheet again.

9. **In general, investors are not even remotely concerned that central banks will spoil their party.**

10. **When everyone is convinced that nothing will change, change will come, and probably with a vengeance. In other words, the conditions are now in place for major corrections**.

Potential triggers of future market corrections: (1) a global recession?

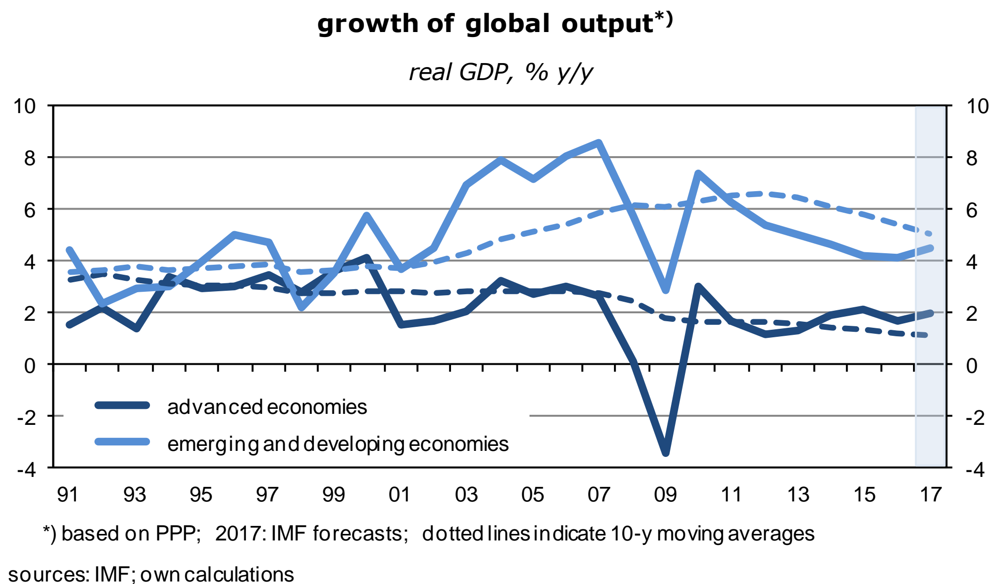
11. But, as always, it is not easy to identify a plausible trigger. **One candidate would be recessions in either industrialized or emerging economies, or both.** In that case, corporate earnings would be expected to decline, dragging down stock prices with them. For bonds this would be good news, though, as recessions reduce the demand for goods and services, widen the output gap and put downward pressure on consumer prices. Central banks would then try to become even more expansionary. The appropriate strategy for investors would be to sell stocks and buy long-duration government bonds.

12. **What would cause a recession? Perhaps overinvestment?** When capacities have been growing too fast, the likely returns on investment go down and at some point fall below the (very low) cost of internal and external funds, followed by write-downs on investments and losses. We are very far from that. Indeed, the weakness of capital spending has been a major concern for at least ten years; it is the likely reason for the weak growth of productivity and the standard of living in the OECD countries.

13. In any case, the OECD think tank has just forecast that America's real GDP will expand by 2.1 and 2.4 percent in 2017 and 2018; for the euro area it expects growth rates of 1.8 percent in both years. **Recessions are presently not on pundits' radar screens**. Not a single economy of the 19-nation euro area will be in recession, not even struggling Greece.

14. **Things are riskier in some emerging economies, especially in China where investment ratios have been in excess of 40 percent of GDP for decades now.** The break-neck speed of the catching-up process must have led to plenty of unprofitable projects in infrastructure, real estate and industry, but so far at least there is no wave of bankruptcies, including bank failures, that could hit the economy of the "communist" country hard enough to cause a

recession. The government still controls the money printing press and can thus in a crisis provide all the liquidity that is needed. The forecasts for China's real GDP growth remain in the order of 6 ½ percent. Since China has a share of 17.8 percent in global GDP, measured in terms of purchasing power parities (PPP) – the share of the U.S. is 15.5 percent –, it **remains the most powerful driver of economic growth for the rest of the world.**



15. India, though smaller than China, at 7.2 percent, is doing even better. Forecasts by the OECD are around 7½ percent for this year and next. In the near term, the likelihood that emerging economies could be the trigger for a major correction of capital markets thus looks remote.

(2) no oil crisis in sight

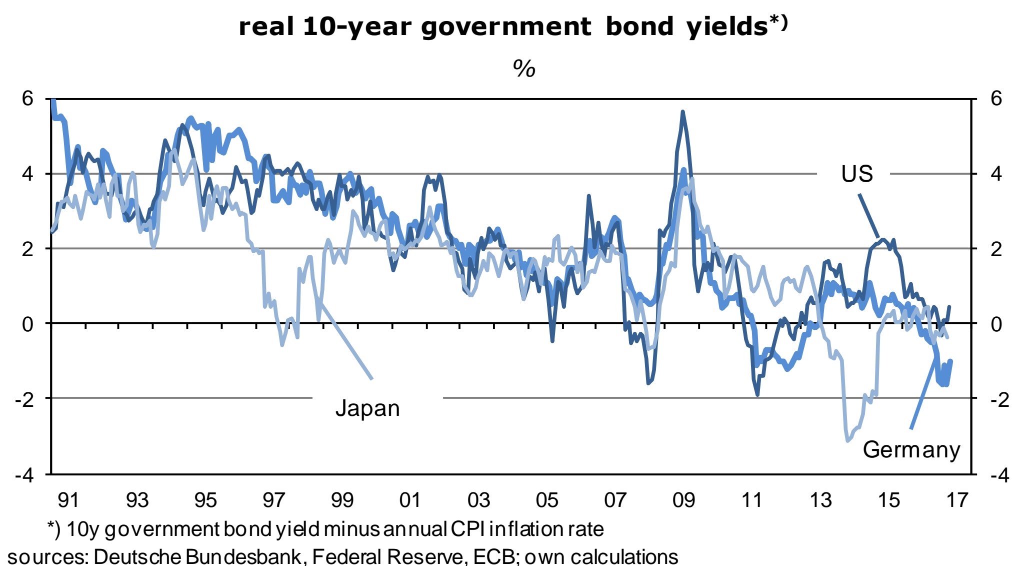
16. **A supply shock such as a large increase of oil prices can also be excluded.** The world is awash with oil. New discoveries exceed the annual growth rate of oil consumption; in 2005 to 2015 proved reserves increased by 2.1 percent per year, compared to 1.2 percent for oil demand (BP Statistical review of World Energy 2017). Moreover, the energy intensity of GDP continues to decline in response to large advances in energy efficiency. One side effect of political efforts to save the environment are (tax) incentives to economize on the use of hydrocarbons. By making it expensive to burn fuel, governments in oil consuming countries prompt consumers and business to switch to increasingly energy-efficient production, transportation and heating systems.

17. At the same time, as I have shown in an earlier Investment Outlook, large and steady price declines of renewables, including batteries, make these more attractive compared to combustion engines. In addition, **nuclear power is making a significant rebound** globally (Germany is the main exception). Since externalities such as decommissioning nuclear power plants or the risks and costs of a major disaster are not correctly priced in, electricity from this source is rather cheap; marginal costs are close to zero.

18. All this tends to reduce the relative price of oil and thus the demand for it. Even though the "OPEC and friends" cartel has had some success in maintaining the lower production quotas agreed upon last year, the longer-term trend of the oil price is down. As it is, falling oil prices mean an improvement in the terms of trade in net oil importing countries – population and GDP-wise the larger part of the world – and thus boost disposable income. **The combination of deflationary effects of lower oil prices and rising real incomes will certainly not be the trigger that brings about a global stock market crash. For bonds, such a scenario is just perfect.**

(3) overpriced bonds to correct?

19. **To be realistic, though, some bonds are significantly overpriced as well.** If you look at the following graph you are forgiven to draw such a conclusion. Since the world's main bond markets are as big, if not bigger than the respective stock markets, a major correction would cause a lot of problems. The "taper tantrum" experience of the U.S. (in 2013) has shown that the mood can change quickly, especially if the central bank sends out signals that the end of easy policies has come. Prices can collapse when everybody decides to head for the exits.

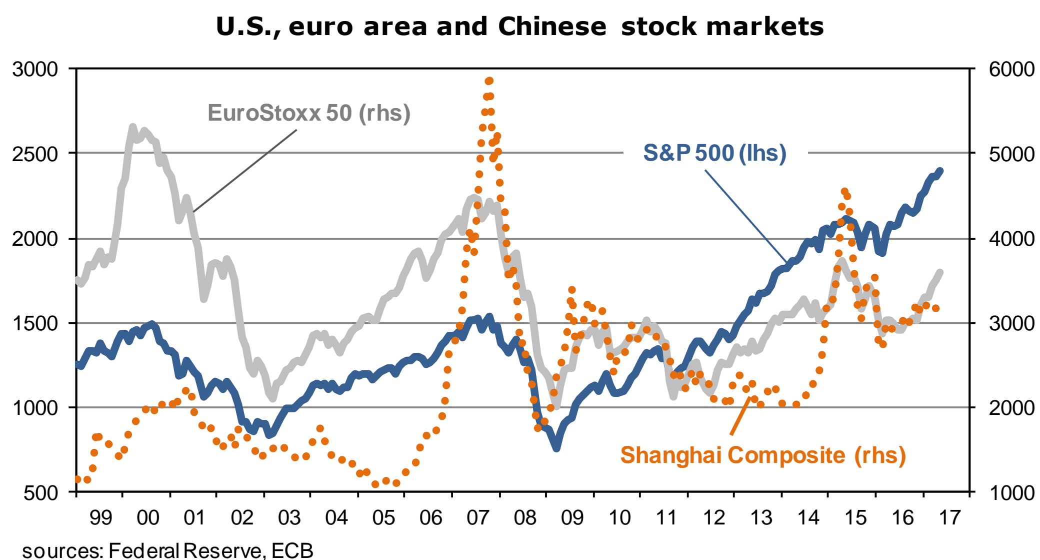


20. I have argued above that the inflation outlook remains quite favorable, that both the Fed and the ECB will tighten very cautiously, if at all. They also want to be predictable. But at least one driver of bond markets cannot really be controlled – the changing role as safe havens for financial investors. **That Germany's real government yield is about minus 1 ½% reflects not so much slow productivity growth but rather investors' efforts to diversify their risks by selling expensive equities, other euro area bonds and generally all assets they are not comfortable with. It has been a plausible strategy to take profits** in various markets. But where to park the liquid funds they receive as a result? The best place is safe haven bond markets, their short ends in particular (which pushes down the entire yield curve). Once the original markets have corrected significantly, the safe haven role of German, Japanese, U.S. and Japanese bond markets will end. This would send them into a tail spin as well and cause major losses. The time has not yet come but it bears watching for such a reallocation scenario to unfold.

(4) popping stock market bubbles?

21. **Another trigger for a global stock market crash could be a repeat of the 2008 experience, the popping of asset price bubbles** such as equities and real estate; some commodities and currencies may also have reached levels which are not sustainable from a fundamental point of view. The main risk is that asset holders are overindebted when the bubbles finally burst and then have to struggle hard to repair their balance sheets. How would they do it? They would cut back on spending and thus cause a recession. What is the evidence here?

22. **Especially in the U.S., stock markets look very expensive**. As the following graph shows, the S&P 500 stock index is presently about 60 percent higher than its previous record in 2007, just before the beginning of the financial crisis. The economy has been in expansion mode for eight years now, full employment is almost here, and monetary policies remain expansionary. The average price-earnings ratio on the basis of current-year earnings expectations is now a lofty 18.8. This suggests, together with a meager dividend yield of 2.0% and the very high price-to-book ratio of 3.1, that **the U.S. is once again the economy with the biggest stock market bubble, and thus an accident waiting to happen.**



23. **European stock markets are in fairly safe territory, at least in comparative terms.** They are certainly not insulated against any shocks emanating from the U.S., and they would also suffer if the bond market correction in the euro area picked up momentum. But a p/e ratio of 15.2, a dividend yield of no less than 3.5% and a relatively modest p/b ratio of 1.6 convey a picture of financial health. The euro area is the wall flower of global stock markets. Investors may also feel reassured by the flow of usually better-than-expected economic data and by equally up-beat political news, especially from France where a new president will have a huge majority in parliament which he intends to use for reforms which are long overdue. Populist parties have recently been losing out in Austrian, Dutch, French and Italian elections while Germany’s xenophobic AfD will likely be reduced to single digits in the September 24 national election.

24. It is **challenging to analyze China's stock market** and the role it should play in global asset allocations. On the plus side is a p/e ratio of just 13.8, the fact that the main stock index is still only about 50 percent of what it was in 2007, and, of course, the strong expansion of the economy. On the minus side are opaque company reports and the unpredictability of policy decisions, including capital controls. The dividend yield of 1.9% and the p/b ratio of 1.8 are so-so, neither too high nor too low. But it is a market that cannot be ignored. Its capitalization is $6.8tr if I trust Bloomberg (WCAUCHIN) and is presumably growing rapidly in step with its economy. In conclusion, I don't see a Chinese stock market crash coming, nor would it make a big difference for the rest of the world at this stage. The country's capital market is still a fairly closed affair.

Exchange rates not in equilibrium

25. Another relevant issue for investors is exchange rates. Recent years had been characterized by a depreciating euro, a firm dollar, an increasingly expensive yuan and a large depreciation of the yen. There have recently been some corrections to these trends, so the question is whether these are the bellwethers of trend reversals.

real exchange rates

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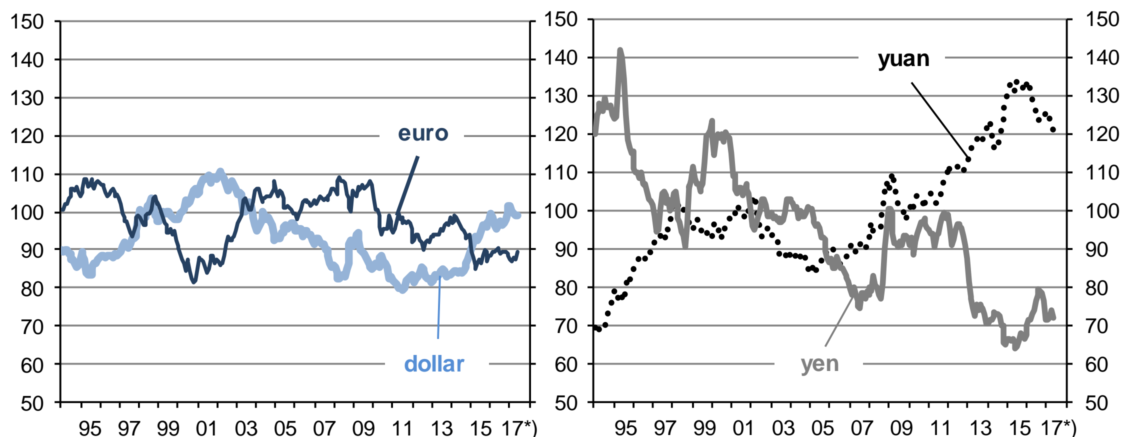


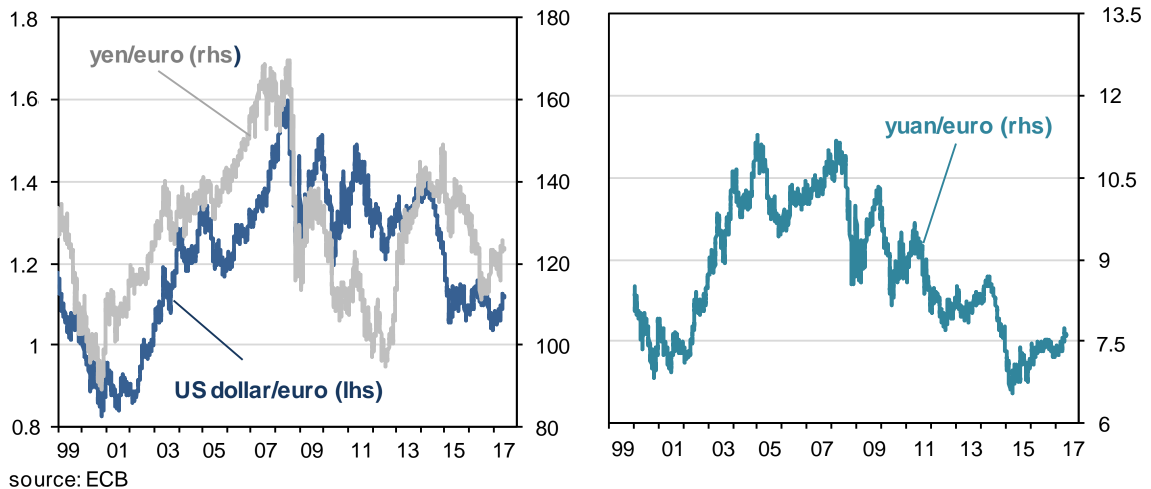
*) last value: May 2017

source: Bank for International Settlements; own calculations

26. **The dollar remains overvalued** on the basis of the large budget and current account deficits. America's international competitiveness is not good, and a significant depreciation would be exactly the medicine a doctor would prescribe to restore it. The attractiveness of the U.S. stock market has so far prevented this to happen. If I am right about the considerable risk that there is once again a large asset price bubble that is bound to deflate, this kind of support will sooner or later fall away – in which case the demand and supply of dollars on FX markets will be determined by changes in the balance on current account and America's savings gap.

27. **So far, the euro exchange rate has rebounded only modestly.** International competitiveness remains excellent, not only in Germany or the Netherlands. It is a key contributor to the surprisingly strong economic expansion that can now be observed across the whole 19-nation region.

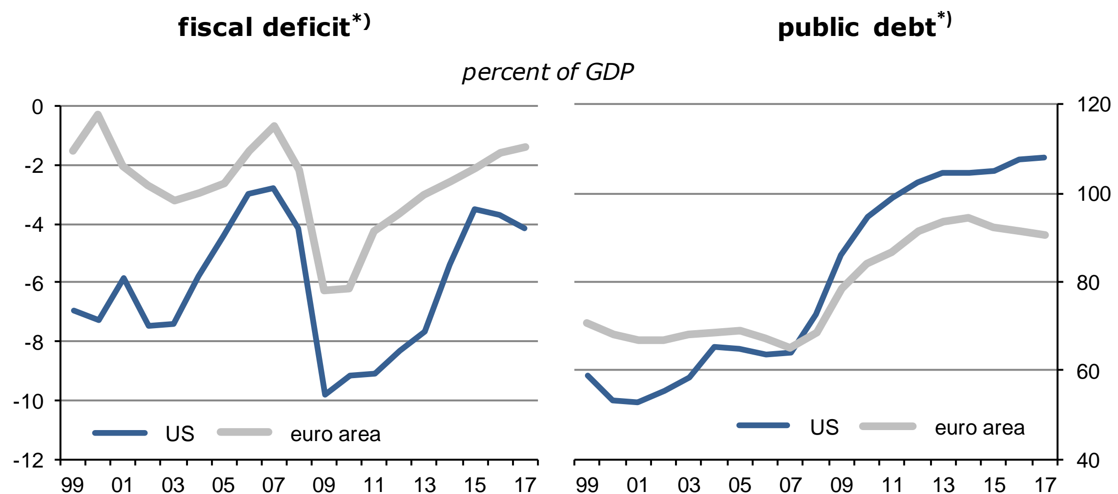
euro exchange rates



source: ECB

28. ECB policies will remain very accommodative as far as the eye can see. **A weak euro is a welcome side effect even though Mr. Draghi would never officially admit that this plays a role in the bank's strategy**. But it certainly helps to put the recovery on a solid footing and to boost inflation. The following graph shows that aggregated government budget deficits and debt levels have improved considerably in recent years – they compare favorably with the situation in the U.S. **There is new life in the euro.**

euro area fiscal policies on the mend



*) 2017 EU Commission projection

source: AMECO

29. **Longer-term, a further depreciation of the yuan does not make sense**, given China's large current account surplus, its fast growth, in addition to positive real money market rates and bond yields. The earlier appreciation may have been too rapid, but I guess it is only a matter of time until the previous high of 6.21 to the dollar will be reached again. Foreign currency reserves have been rising in recent months, a sign that capital flight has ended or is not so strong any more. A stronger yuan will also appease the U.S. administration which suspects that China is manipulating its exchange rate at the expense of America's economy.

30. Why should the yen continue to depreciate? To be sure, real policy and money market rates are negative, as are government bond yields, growth is weak, and both government budget deficits and debts are huge relative to GDP. But this has been the case for a long time and is not the stuff that should drive the yen even lower. In the meantime, industrial production expands briskly, GDP as well (by Japanese standards) while the current account surplus is heading for an impressive 3.5 percent of GDP this year. **The yen is undervalued.**

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