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Wermuth's
Investment Outlook

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1. **Market participants assume that the financial crisis is either over or on the mend, or that it does not matter much. If they have invested accordingly they have done very well in recent weeks. Risk aversion has come down again, stock markets are rallying, especially in emerging economies, as are the prices of most commodities.**

2. **According to the prevailing view, the liquidity crunch has successfully been contained by determined central bank actions.** Banks, meanwhile, have come clear about their losses and have made the necessary if painful write-downs. From now on they will be more cautious than in the run-up to the crisis, which is welcome. But apart from this it is back to business as usual.

3. While the US economy will slow, the **world economy as a whole has so much momentum that it will continue to expand briskly.** US consumers, who had been the main drivers of global demand, are about to be replaced by households and firms in China, India, Russia, Brazil and the oil and commodity exporting countries. As a group, they have even more purchasing power than American consumers. Not only that, because they are still so poor they also have a huge unsatisfied demand for goods and services, and they are financially sound.

4. **The IMF has just reduced its forecast for 2008 world GDP growth from 5.2% to 4.8%, in a concession that the financial crisis will have some negative impact, but 4.8% is still a very strong number. It would be the sixth year that the world economy expands at a rate of around 5%. In such a scenario inflation, not deflation, will soon become the main worry of policy makers. Sell bonds!**

5. **For me, the above story is too good to be true. Markets either neglect several major risks or view them as nothing but irritants, not as potential show stoppers.**

6. For one, banks' recent policies of "originate to distribute" (OTD) via securitization must have led to a significant increase of risk taking, leverage and bad loans. **Who is holding these low-quality assets? The credit crunch is still very much with us.**

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7. Second, **the decline of the US housing market seems to turn into a crash.** The numbers are getting worse and worse. In the past, comparable developments had invariably led to recessions which in turn used to drag down the rest of the world economy.

8. Moreover, even though **the dollar** has already devalued a lot it continues to fall - this will result in some significant dislocations. And, in case we forgot, **we are in the midst of an oil crisis**. Shouldn't record-high oil prices reduce real disposable incomes and thus consumer demand in all oil-importing countries? Is there any evidence that the equation oil price explosion equals recession does not hold any more?

9. To start with the OTD phenomenon: ten years ago the total amount of derivative products was $12tr, now the number is about 30 times larger and thus six to seven times larger than world GDP. **Credit risk has become increasingly tradable** thanks to credit default swaps and asset backed securities. There has not only been a progressive shifting around of risks inside the world's financial sector, an increasingly large share of the risks has been downloaded to the household sector. One indication of this is the de facto end of defined benefit in favor of defined contribution pension schemes – households know how much they have to pay for retirement but are no longer sure what they will get when the time comes. Hedge funds have also developed into major risk takers, as have been off-balance sheet vehicles of commercial banks and proprietary trading desks (if not hedge funds) of investment banks. I would conclude that these developments have provided a strong incentive to increase the overall level of risk taken by the participants in financial markets.

10. **The financial industry had many wonderful, ie profitable years**, caused by falling inflation rates, low real interest rates, subdued volatility, accommodative monetary policies (not least in form of the Greenspan put) and a huge increase of international capital flows. At the same time, the world economy has neither experienced a recession nor a financial catastrophe. It has been an environment that has lent itself to excesses. These typically come to light when the goldilocks period ends. Japanese readers know what I am talking about.

11. What is the true value of credit portfolios these days? **Banks seemed to have discovered a money making machine** by originating loans, bundling them into securities and selling them off into the market, after having obtained favorable seals of approval from obliging rating agencies. That the **agencies had a conflict of interest** had neither been noticed by the buyers of these "sophisticated financial engineering products" nor by the regulators.

12. As it was, the banks earned handsome originating and trading fees and were able to keep their balance sheets clean in the process: originate and distribute! **The incentive was clearly to originate as many loans as possible and to forget about traditional credit standards.** Credit departments were de facto outsourced to the rating agencies. "Covenants light" was one of the buzz words. I take on more risks, but I don't keep them.

13. **Some banks, though, have made the mistake to lend money to the buyers of their asset backed securities.** These are now discovering that they have ended up with assets which have no market price. Especially those hedge funds are in trouble which used leverage to meet ambitious performance targets – and the lending banks along with them.

14. **Another problem are the structured investment vehicles (SIVs) and conduits** which are often off-balance sheet but closely related to banks. They use to borrow short (mostly via Asset Backed Commercial Paper) and invest in long-term securities. As a significant source of their funding has dried up in response to sudden doubts about the quality of the bonds backed by assets such as mortgages, corporate loans, credit cards or student loans, these vehicles are forced to sell their assets, but have problems finding takers at reasonable prices. Since they usually hold bank guarantees, the risk is that their assets move back onto the balance sheets of these banks, impair capital adequacy ratios which then might lead to panic selling, and so on. We are talking about $300 to 400bn.

15. For now, many players are still in a state of denial, and seem to have resorted to mark-to-model rather than the more conservative mark-to-market valuation method, hoping that liquidity will return some day. They may be lucky, but then they may not. So far, there are **no signs yet that a new money market equilibrium is about to be reached. Pricing problems continue to persist and have begun to require emergency measures.**

16. One such is the new **$80bn fund, or super-conduit,** launched by Citigroup, Bank of America and JPMorgan which will buy asset backed securities from these vehicles in an attempt to allay fears of a downward price-spiral that would hit the balance sheets of the big banks. The fund has the blessing of the US Treasury. According to last Monday's Financial Times "… it is likely to be extended to European banks as well, and may even be extended to the euro market." **In essence, the big banks will buy paper from themselves in an attempt to create the impression that there are market prices for the assets of the SIVs after all.** In this way the markets for commercial paper and other funding instruments might spring back to life.

17. This may well be wishful thinking. The credit crisis is not yet over. Central banks, for instance, continue to be very concerned about the risks to financial stability. But **how about the argument that the crisis is not particularly relevant for the world's stock markets or its real economy?** I disagree, for several reasons. If banks find it more difficult to get funding, partly because they don't have trust in the quality of each other's assets, they will tighten their lending standards. For households and firms it gets more difficult to borrow and spend. This reduces demand, GDP growth and thus future corporate earnings - which is obviously market relevant.

18. Banks' higher risk aversion also leads to **less lending to hedge funds and private equity funds**, the players which had been at the heart of the stock market boom and the banks' earnings miracle. Banks have to respond by cutting costs which is another negative short-term effect. Since take-over activity is now stalling, an important driver of the stock market has gone into hibernation. This means the cost of raising equity will increase which in turn reduces the growth rate of capex.

19. **And then there is the US housing crisis.** How does it affect the outlook for the US economy? At least one major player, the Fed, is rather worried about the prospects for 2008, as reflected in the minutes of the last FOMC meeting.

20. **The present situation of the American economy is quite benign, though,** and has supported the story outlined in the first paragraphs of this Investment Outlook. It is by now certain that the third quarter had been fairly strong. Real GDP probably expanded at an annualized rate of 3 to 3 ½%, in spite of the fact that residential investment continued to decline at a rate of 15 to 20%, and in spite of flat corporate capex spending.

21. It seems that **net exports have contributed about two full percentage points to the GDP growth rate**: the weak dollar in combination with a still-booming world economy and steeply rising revenues in oil exporting countries have boosted real exports while reducing real imports. This will probably continue for some time.

22. **What will not continue is the strength in household consumption**. I must admit that I have predicted a weakening of US consumer spending several times in the past. Could I be right this time? The most recent numbers, for August, show that consumers are still doing alright, thank you very much. Total nominal incomes were up no less than 6.8% y/y, and real disposable income an impressive 4.4% y/y. Retail sales have also held up well so far. But look at the following list:

    a. The **prices for homes, consumers' most important asset, have begun to fall sharply**, for the first time in living memory. There has been an overinvestment in real estate. Menegatti and Roubini have recently estimated that the "reduction of housing wealth from a 10 percent fall in prices could result in a negative impact on consumption as a share of GDP of about 1 percent." The wealth effect is spread over time, but it materializes considerably faster than the one caused by changes in the value of equity portfolios.

    b. **We are probably only at the early stage of house price deflation**: price-to-rent ratios are still too high, as are real estate inventories. The ongoing fall in housing starts from its January 2006 peak - by no less than 48% to last September - shows that the demand for new homes is extremely weak.

    c. Risk-averse banks are demanding **larger down payments** from would-be buyers which forces these to save more /consume less.

    d. Since **home equity withdrawals have largely come to a halt -** because they work best when house prices are rising, not falling -, one important source of spending power is now clogged up. The various studies that analyze this phenomenon disagree about the importance of the effect, but not about its sign. Greenspan and Kennedy, for instance, estimate that, between 1991 and 2005, about a quarter of home equity extraction was used for private consumption. Jan Hatzius of Goldman Sachs, using another approach, arrives at 34%. To put this into perspective, in 2005 the total amount of home equity withdrawals had been 6.4% of US disposable income, and is now approaching zero.

    e. The credit crunch in mortgage markets is now **spreading to other types of consumer credit** such as credit cards.

    f. The University of Michigan **consumer confidence survey has fallen** to 82, from 96.9 in January and compared to a 10-year average of 94.7; the expectations component fell to a recession-like 71.6.

g. **Record high oil prices**, not cushioned by a strong dollar or high gasoline taxes, are now massively reducing discretionary incomes.

h. In spite of positive job creation (employment was 1.2% y/y) US **labor markets are clearly slowing**; unemployment is creeping up. Unit labor costs have begun to rise rapidly as output per hour has slowed to an average of 0.5% y/y (in Q3 '06 through Q2 '07) while hourly wages are up by about 4% y/y.

23. **Hardly anyone is yet predicting a recession in the US**. JPMorgan, for instance, actually expects an acceleration of real GDP growth to 2.7% y/y in 2008, after 2.1% this year, with net exports as the main driver. The implication is that consumer spending will at least hold up. **This also looks like wishful thinking to me**. The IMF yesterday said it expected US growth to be only 1.9% in both 2007 and 2008, with the risks clearly on the downside. A trailing S&P500 price-to-earnings ratio of 18 looks rather lofty in view of deteriorating corporate earnings prospects.

24. In the present global expansion which began in 2003 strong American domestic demand growth had stimulated other countries' exports. This is now going into reverse, and the question is whether it can work. **Can the world thrive while America tightens its belt? It has not worked in the past,** simply because the US had such a dominating weight in world GDP. The US sneezed, the others got pneumonia. When, in the wake of the stock market collapse, US growth slowed from 3.7% y/y in 2000 to 0.8% in 2001, global growth slowed from 4.8% to 2.5%, ie it moved very much in step. In the meantime, America's weight has shrunk to 25% in terms of market exchange rates, and to 20% in purchasing power (PPP) terms. Even so, it is the largest single economy and any slowdown of growth will have a very negative impact on the rest of the world.

25. **The emerging economies now account for 48% of world output, and they are growing at the breathtaking rate of 8% this year, as in the years before.** Since their saving and investment ratios are very high, mostly because public pension systems and the financial sectors are underdeveloped, their capital stock has been growing rapidly as well, with the nice result that inflation remained moderate. East Asia thus used to be an exporter of price stability. It helped that wage inflation was well contained because of an oversupply of labor, and that monetary authorities intervened massively in foreign exchange markets in order to limit the appreciation of their exchange rates.

26. This benign picture seems to be changing. **Ample liquidity, the flip side of the FX market interventions, had first led to an inflation of asset prices in that part of the world. It is now driving up consumer price inflation.** In China it has reached 6 ½%, up from zero a couple of years ago, in India it is 7 ½%, and in Russia 9 ½%. Since rising inflation can lead to social tensions and thus to unrest and political instability, these countries are about to tighten.

27. So **emerging economies' interest rates** (which are still extremely low both in real terms and relative to real GDP growth) **are on the way up**. Together with more rapidly appreciating currencies, record high oil prices, slower growth in the US and tighter bank lending standards in the wake of the worldwide credit crunch this will reduce the growth rates of these countries. Markets' enthusiasm for their ongoing economic dynamism is based on wrong premises.

28. The likelihood that both the **euro area and Japan are past their cyclical highs** means they are not likely to fill the coming growth gap caused by weak domestic demand in the US. The global growth outlook will probably be revised down further.

29. For the euro area in particular the **appreciation of the euro will act as a strong brake on growth.** Since the emerging economies are still managing their currencies, by limiting their appreciation against the dollar, America's need for a substantial devaluation of its trade-weighted exchange rate means the burden will fall disproportionally on Europe's shoulders. The euro will continue to gain against the dollar.

30. Since the **ECB is not yet willing to consider a rate cut**, as headline inflation will rise to 2 ½% in coming months, while Q3 GDP growth will be 0.7% q/q and, as the IMF says, 2.5% for the year as a whole, a stimulation of domestic demand via easier monetary policies is not yet in the cards. The only thing Mr. Trichet is prepared to do is to point the finger at China's irresponsible exchange rate policy – if China would let the yuan revalue more, as it should, given the fundamentals, the euro would not appreciate so much.

31. It is clear that this is mostly empty talk and will not change China's policies. It is intended for home consumption, to deflect criticism from the ECB. As everywhere in the large economies, monetary policy does not really take into account international repercussions. From the regional perspective any easing would be premature. **No help for the flagging US economy from that side either. On the other hand, the further likely weakening of the dollar to $1.50 per euro and beyond means that America's price competitiveness vis-á-vis its third largest trading partner and main competitor on world markets continues to improve decisively. In this way Euroland helps to stabilize the US economy.**

32. **It is strange that euro area government bonds have been so weak**, much weaker than US Treasuries, the bonds of a country with a depreciating currency. Yields are now almost at par. The increase of yields since the beginning of the financial crisis in early August can be explained by the still fairly positive data flow from the real economy, but the outlook for inflation could hardly be better. Unit labor costs of about 1% y/y are the main determinant, while the strong euro holds down export and import price inflation and thus inflation in general. Somehow markets should also honor the fact that the euro area budget deficit will fall to 0.7% of GDP; compare that to America's 1,7% and Britain's 2.7%.

33. **Strange also that the euro area stock market is fairly unimpressed by the strength of the euro** (up 7.2% since the beginning of the year). Germany's DAX index with its relatively small share of financials even gained 20% this year. At 13, Euroland's price-to-earnings ratio is quite low, though, and the risk premium is a high 5 ½ percentage points (7.72% earnings yield minus 2.22% for real riskless long-term bond yields); this may reflect the expected negative effects on corporate earnings of an overly strong exchange rate. Going forward, European stocks driven by domestic demand should do relatively well compared to exporters.

34. So what will be **the impact of the latest oil price rally on the global economy?** Compared to 2003 when the West Texas Intermediate brand averaged $31 a barrel, the annual spending on crude has increased by about $1,800bn a year, assuming today's spot price will persist. This is the equivalent of 3.4% of this year's global GDP of $53,352 (the number is from yesterday's IMF Outlook).

35. Obviously, the impact on final demand in the group of countries which are net oil importers is much larger. This includes the US, Japan, China, India, euroland, and most of central and eastern Europe (except Russia) as well as east Asia. **These regions are transferring a huge amount of money to the net oil exporting countries whose import demand for non-oil goods and services cannot keep pace with their revenues** (although some of them such as Russia and Nigeria are trying hard). The higher the oil price the more severe the effect on global growth.

36. For a long time, rising oil prices could be shrugged off is fairly irrelevant for consumer and business spending because in "real" (CPI adjusted) terms they were considerably lower than at the beginning of the eighties, at the time of the second oil crisis. This has changed, and the full blow of the most recent oil price explosion will soon be felt. **We are experiencing a genuine oil crisis.** In the past, an oil crisis has always coincided with a significant slowing of world economic growth.

37. **In the first round, high oil prices lead to rising headline inflation which prompts single-minded central banks such as the ECB to keep the foot longer on the brake than warranted by the coming inevitable slowing of GDP and employment growth.** The increase in idle capacities will inevitably lead to a decline of corporate profits and thus of stock prices. So we are approaching a point where it is not wise to be overweight in stocks any more, especially those for which oil is a major input (such as transportation, chemicals) or which belong in the category of discretionary spending (which suffers from the reduction of consumer purchasing power). Utilities are major oil consumers but they will actually benefit from higher oil prices because they usually operate as oligopolists or even monopolists and are thus able to pass on their cost increases – they frequently can even improve their margins.

38. **One of the main beneficiaries of the new oil crisis is Russia**. For a while last year and earlier this year it looked as though the country's huge current account surplus would quickly disappear under the impact of falling commodity prices and booming real imports (which were growing three to four times faster than real exports). This would have led to an end of money printing via FX market interventions, ie result in slower liquidity growth, lower equity and real estate prices, and to lower GDP growth.

39. **Such an outcome has once again been pushed forward into the future**. Russian imports continue to thrive, annual M2 growth is back in the order of 50%, and inflation may well accelerate above 10%. In real terms, net exports are a drag on the economy, but domestic demand gets another push. One plausible implication is that the **central bank will allow the rouble to appreciate more vigorously** – currency reserves are $425bn or about one third of GDP and thus unnecessarily large. Whether interest rates will be raised as well is not clear because this could spell trouble for those banks which have borrowed heavily abroad and are now faced with much stiffer conditions. The Central Bank of Russia had already been forced to supply some extra funds to the banks and to reduce minimum reserve ratios. But overall, the stock market which had been a sort of wallflower this year, will do well, at least relatively. Measured in dollars (as the RTSI$), the coming appreciation of the rouble will provide an additional kicker.

40. **Bottom line: US stocks should do relatively well, if not as good as Russian stocks. Euroland and British stocks will suffer from the strong currency. Financials are not yet out of the woods. Since the risk of recession is rising, the outlook for inflation will improve which argues for European government bonds. The spread between US Treasuries and Bunds will widen again. The Fed will lower rates further, and the ECB will follow in due course. Commodity prices are so high that the risk of a major correction is rising all the time. Unless there is a clear trigger, such as improved peace prospects in the Near East, a big increase in oil inventories, or signs of a significant slowdown of world growth, it is risky to go short. Demand for commodities remains strong. On the other hand, we should not get carried away: the higher the prices the smaller the additional demand for any given growth rate of global GDP. Markets work.**

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