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Wermuth's
Investment Outlook

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by Dieter Wermuth*

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1. If I may use a picture appropriate for a November report, the **four apocalyptic horsemen** are still riding through the world economy. So far they have not yet brought death as they are supposed to; they are more like participants in a Halloween event rather than heralding the end of time. Also: they are mostly galloping through the US while the other countries have been spared of their destructive powers - more or less.

2. The modern names of the horsemen are dollar **depreciation, oil price explosion, US housing crash and credit crunch.** Each one of them can have a considerable impact on the structure of the global economy and the dynamics of growth, and together they could spell a multi-year adjustment process that is accompanied by recession and deflation or, alternatively - depending on the policy response -, by inflation and thus stagflation.

3. What we are seeing here is mainly the correction of previous disequilibria and thus both overdue and desirable. But these processes carry their own risks: they can gain so much momentum that it may become difficult to control them. Developments in Japan which followed the bursting of the housing and stock market bubbles there provide a daunting example of what may lie in store. **Up to now, things are proceeding smoothly**. One major problem is that some of the processes, such as the re-allocation of currency reserves or the valuation of bank assets are outside the domain of national monetary and fiscal decision makers.

4. That the dollar continues to decline is only surprising if one assumes that the purchasing power parity represents a natural equilibrium. The world's richest and largest country has been, for many years, the largest net capital importer. Since the dollar is the leading reserve currency to which many countries have tied their exchange rates, foreign monetary authorities were forced to pick up the supply of dollars which is the mirror image of those capital imports and in the process amassed reserve assets far in excess of any fundamental requirements. **There are obviously more dollars around than investors want to hold**. The downward pressure on the dollar exchange rate will persist until the prices of dollar assets become attractive again. Even though the US current account deficit has been shrinking, it is still in the order of $780bn per year. Who will buy all these dollars, especially if US real interest rates are on the way down?

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5. While the dollar depreciation helps in slowing domestic US demand and boosting net exports (and improving the earnings situation of US exporters and multinationals), it **will not be enough to prevent a reduction of overall American GDP growth.** The demand of private households is the key determinant because it accounts for more than 70% of aggregate demand. The outlook is not good any longer. It is the main reason why near-term consensus forecasts for quarterly annualized GDP growth are now zeroing in on something like 1 ½%.

6. **Forecasts of an early death of the American consumer have been just as frequent as they have been wrong. This time it could be different**. In his blog, Nouriel Roubini of New York University lists no less than eight factors: 1. the wealth effect of falling home prices, 2. the decline of home equity withdrawals for consumption purposes, caused by those falling home prices, 3. the ongoing and worsening credit crunch limits the ability and willingness of consumers to borrow, 4. the surge of mortgage servicing costs resulting from the $1tr of ARM (Adjustable Rate Mortgage) resettings in the next 18 months, 5. the reduction in household disposable income caused by record high oil and other energy prices, 6. the sharp decline of consumer confidence, 7. the significant deceleration of job creation, and 8. the fall in the net worth of the household sector for reasons other than the fall in home prices: a high and rising debt servicing ratio and a correction of stock markets. For Roubini, the slowdown in consumption has actually begun already.

7. **Both the price effect** – the dollar depreciation in real terms – **and the so-called income effect** – the decline of US capacity utilization rates due to slower consumption and GDP growth – do indeed **argue for a shrinking external deficit**. The ongoing reduction of the US trade deficit means the other countries will have correspondingly lower surpluses which in turn means that for them foreign trade will be a drag on economic growth. This is one channel through which the US crises are transmitted to the rest of the world.

8. While the negative impact of the weak dollar, the ongoing housing crisis and the shrinking US trade deficit on global growth is straightforward, it is **not quite as clear what the other horseman, the US credit crunch will do.** One thing is certain: it does not have expansionary or inflationary effects. Banks and institutional investors such as insurers and hedge funds are still busy writing down their so-called structured financial assets to more realistic levels. According to Moody's, banks alone still have a need to revalue about $200bn of their asset backed securities. Balance sheet ratios will deteriorate accordingly and force them to either sell assets, reduce lending or increase their capital base. To recall: it took the Japanese banks more than a decade to restore their balance sheets, in spite of zero central bank interest rates for most of that time.

9. Part of America's capital imports must have consisted of **selling supposedly high-grade structured products to unsuspecting European banks and institutional investors** who are now also forced to write them down and reduce lending and investing. While Europe's financial systems are sufficiently robust to cope with this challenge, at the margin at least they have to do something against the deterioration of their ratios as well. Moreover, all banks which rely on money markets for funding are suffering from the wider spreads and tighter conditions there. The German Landesbanken are just as affected by this as some East European banks which don't have strong deposit bases.

10. On balance, America's various crises are mostly negative for US growth; the consensus is that they will not bring about a recession, though. Expansionary monetary policies will be powerful enough to stabilize demand. Even so, **the weaker US economy will have a negative impact on the rest of the world.** Almost everywhere, forecasts for real growth are thus scaled down. It is virtually certain that next year's global growth rate will be less than this year's. JPMorgan, for instance, expects a real GDP growth rate of 2.2% y/y for developed markets (the bank's analysts actually predict a new acceleration in the US, beginning in a few months from now), and of 6.3% for emerging markets. This implies that the **growth rate of world output will be less than that of potential GDP: for the first time in six years there will be some increase in economic slack.**

11. This is good news for inflation. In the wake of booming commodity prices (which in turn have been driven by the world economy's long-lasting boom) **headline consumer price inflation has been on the rise.** In the US and the euro area it is now considerably higher than central banks like (3.5% and 2.6% y/y). Ex food and energy inflation is still in the comfort zone of close to 2%, but the longer headline inflation remains high, the likelier it gets that core inflation and the all-important inflation expectations are dragged up as well.

12. **In emerging economies**, inflation **has also been on the rise, in spite of generally strong currencies.** Their consumer baskets contain a larger share of energy and food, the two categories which have become particularly expensive recently. The region's increase in inflation goes beyond the usual difference that results from the Balassa-Samuelson effect. With the exception of China and Russia, where real interest rates are still extremely low and need to be raised a lot, inflation does not look like it might become a serious problem. Overall, monetary policies are mostly on hold.

13. For two main reasons, **commodity prices have probably peaked**: global growth is losing momentum, and the inflation rate of key commodities has exceeded the growth rate of global nominal GDP by factors three to seven over the past four years. The coming slowdown of global growth is, of course, partly caused by high commodity prices themselves. These have drained purchasing power from households and firms in commodity importing countries, ie in the larger part of the world economy.

14. **Political events in the Near East can reverse the new trend of falling commodity prices any time,** but for purely economic reasons it is not clear what has changed between last September when the oil price was 70$ and today when the price is 92$. Confidence indicators have been pointing down rather than up in the richer parts of the world, consumers are likely to tighten their belts, and industrial production will slow, all of these reasons for a slowdown of commodity demand.

15. **Some analysts think the world is heading toward seventies-style stagflation.** I don't think this is likely as long as labor remains unable to push through significantly higher wage increases. There had been some initial evidence of this in the US (where full employment had de facto been achieved); in the meantime, US wage inflation has slowed again. In Europe and in Japan, there has not been the slightest acceleration of wage growth. The negotiating power of workers has been, and remains weak under the onslaught of technical progress and the rapid integration of the world economy (the China effect). No consumer price inflation without wage inflation!

16. After America's benign producer prices and soft retail sales yesterday, and moderate core inflation numbers today, the **Fed has room to cut the funds rate further to 4.25% on December 11.** Governors remain concerned about the potential fall-out from the credit crunch and the housing slump, and correctly perceive the acceleration of headline inflation as a spike, ie nothing to worry about.

17. **The ECB is not yet under pressure to cut rates.** Given its strong focus on headline inflation which is far above target, plus robust GDP growth (2.8% saar in Q3), Mr. Trichet and his colleagues might actually be tempted to raise rates beyond the present level of 4.0%. On the other hand, at last week's press conference he seemed quite concerned about the strong euro and the risks associated with the US financial crisis. So the best bet is that the ECB will remain on hold and that the policy rate differential between the US and the euro area will shrink to 25 basis points in December.

18. **Government bond markets of these economies, but also those of Japan, the UK and Canada are well supported by monetary policies, the expected slowdown of economic growth and the predictable peaking of commodity prices and inflation in general**. It remains a puzzle that euro area long-term yields are only 10 basis points lower than US Treasury yields, given that the strong euro suggests a better inflation outlook, that headline inflation is a lot lower, that the cost-of-carry is less, and that euroland's public sector deficits are much smaller than America's. It also does not rhyme with consensus forecasts which predict a slightly higher GDP growth rate for the US. It seems that bond market investors are either more downbeat about America's real economy than suggested by consensus forecasts, or consider Treasuries to be safer instruments than European government bonds, or both.

19. **Real bond yields are not high any longer**. This holds for all three large economies of the OECD area, the US, euroland and Japan. But they are neither particularly low. They are still well above the levels reached two years ago - by more than 100 basis points in the 10-year range. I expect a return to these yields in euroland and Japan because the combination of strong currencies and slowing growth will considerably reduce inflation expectations.

20. **Corporate bond yields** are another matter. Under the assumption that the above analysis is consistent, US bank IOUs in particular continue to be too risky, as bad loan problems mount. Even non-bank bonds are more at risk than usual: the business cycle has probably peaked. In a situation of slowing demand, borrowers who are highly leveraged - and there must be many of these after years of easy money - will find it difficult to service their debt. European corporate bonds are not as exposed because Europe is lagging in the business cycle; moreover, policies in the earlier years of the decade had been less accommodative than in the US.

21. **I like rouble-denominated bonds of borrowers such as Gazprom, Lukoil, Sberbank or Gazprombank**, even though their real yields are negative, for two reasons: attractive yields plus the not-so-small probability that the rouble will soon be allowed to appreciate, especially against the dollar, but possibly also against the euro. Russia has an inflation problem (CPI will reach 11% y/y in December, much more than the initial target of 8%) which is caused by forex interventions (net almost $10bn a month) and the resulting flood of liquidity. Since employment and GDP growth rates are high, some further loss of competitiveness in the tradables sector is probably acceptable. Letting the rouble float is the easiest way to cool exuberant domestic demand and inflation. In a country with a very uneven income distribution, inflation hurts mostly those who are poor.

22. The outlook for interest rates is one key determinant for **exchange rates**. So far, the main story was simple: buy currencies whose interest rates are either high or rising, and sell those whose interest rates are either low or falling. A secondary set of determinants are balance on current account deficits and surpluses. This explains the strength of euro and renminbi, the absolute weakness of the dollar, and the relative weakness of yen, Swiss franc and sterling.

23. I have the impression that the **importance of current accounts is on the rise**. It seems that market participants have suddenly discovered that **Japan is running a surplus of $200bn** which generates a demand for yen of almost $1bn per working day. Carry trades still make sense because there is a strong pressure to export capital from Japan, but they are no longer driving the yen exchange rate – which has suddenly become the star of the forex markets. Indeed, once investors begin to believe that the interest rate gains from these trades are likely to be less than the likely losses from foreign currency depreciation, the yen appreciation could turn into an avalanche. It looks as if we were near such a point.

24. **The euro benefits from stable interest rate expectations, less from a favorable current account situation;** the surplus is a modest 0.25% of GDP. Consensus forecasts for GDP growth in 2008 are around 2% y/y which is somewhat less than the growth of potential GDP. In general, as the ECB has just pointed out again, the euro area is not suffering from any serious imbalances which might endanger the moderate expansion. Investors cannot do much wrong by investing in euro assets, but the potential gains are limited after the strong appreciation that has occurred already. That said, if the dollar decline turns into a rout - perhaps triggered by a more aggressive currency diversification by large dollar-holding central banks - the euro would still be the prime destination for investors looking for a solid alternative; it could appreciate well beyond 1.50$.

25. **Sterling is rising against the US dollar, but continues to slide against the euro**. The 5.75% level of the policy rate is presently less relevant than the expectation that it will have to be cut. The Bank of England indicated yesterday that two interest rate reductions will be needed to stem an economic slowdown. According to Mr. King, the UK will suffer from the global credit squeeze, from falling equity prices and currency tensions. A weaker currency is the appropriate recipe when growth is at risk – it is also needed to reduce or eliminate the very large current account deficit. For a long time it had looked as if the Bank of England was trying to keep sterling in a narrow band against the euro. This is not the case any longer. To recall, the present economic expansion had to an important extent been triggered by a large depreciation of sterling. Given this happy experience policy makers probably don't mind another one. Don't be long the pound.

26. **For OECD stock markets, the coming slowdown of growth is bad news**. Productivity increases will turn out smaller than in recent years, and it will be harder to raise prices. In the euro area, the stronger euro will make life more difficult for exporters and import-competing firms. On the other hand, since the likely terms-of-trade improvement and the decline of oil prices will improve disposable income, companies which focus on the domestic market should do relatively well. In the US and, to a lesser extent, in the UK, exporters should benefit from depreciating exchange rates, just as anybody who faces import competition, while the weakening of domestic demand will hurt companies which specialize on that segment. Japan is in a similar situation as the euro area.

27. Going by price to earnings ratios, or risk premia, **US markets are not cheap any longer**. As usual, European stocks cost much less. This implies that the earnings outlook for American firms must be a lot better. Do we believe this?

28. **Among emerging markets, Korea is probably the most attractive one at this point.** The country benefits from a relatively undervalued currency and its strength in products used for infrastructure projects, such as steel and shipbuilding. It is also strong in low-cost electronic consumer goods and passenger cars. **Chinese stocks are totally overvalued**, but as we have learned, bubbles can last for much longer than rational analysts would think feasible.

29. **Finally, Russian stocks: domestic demand remains the driving force of the economy**. Since the terms of trade have recently improved again, real incomes have grown briskly. The government is also in a very comfortable financial position and has announced a steep increase in spending on infrastructure. So it is plausible that retailers, telcos, metals (including steel and nickel), construction and real estate are doing well. The oil firms are mostly suffering from exploding costs and high taxes, and their output is hardly rising. Utilities will also remain out of favor for cost reasons but could gain when the consolidation process accelerates. As everywhere these days, banks are regarded as rather risky assets, especially those which don't have a solid deposit business. Sberbank is obviously in a favorable position in this regard but will not perform well as the whole sector is under pressure.

30. **What will happen to Russian stocks if commodity prices decline from here on?** One can argue that even if they fall by 20 or 30%, they would still be much higher than predicted only one year ago. While this is true, it is also clear that the earnings momentum would suffer. One transmission channel between changes in commodity prices and corporate earnings is foreign trade. Since real imports are rising three to four times faster than real exports, the huge trade surplus would quickly erode once export prices collapse. One important source of liquidity would therefore dry out – which would pull the rug from under the domestic demand-led growth story. If, however, private capital inflows into Russia continued, this would mitigate the negative impact.

31. Another stabilizing force will certainly be government spending. The budget surplus has been shrinking lately, but remains large. And there is no lack of reserves, not to speak of the government's ability to borrow money. On average, Russian stocks trade at a trailing p/e ratio of 12 to 13 and are therefore not really cheap. But firms have mostly large untapped productivity reserves while domestic demand is still growing at close to 10% in real terms. **So one could be optimistic in the medium term – near term, the correction in international stock markets and the likely fall of commodity prices does not bode well.**