



# Wermuth's Investment Outlook

**December 2007**

**ZEIT online • HERDENTRIEB**

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December 20, 2007

1. For investors, the main question at this point is whether we are heading toward inflation, a temporary slowdown of growth, followed by a new expansion of the world economy - call it **Scenario 1** -, or whether it is **Scenario 2**, high inflation now, but large negative effects on the real economy from the unwinding of the world's various imbalances, which would lead to very slow growth or even recession in major parts of the OECD, and a rapid deceleration of inflation afterwards. Both scenarios are plausible. But they are mutually exclusive, and the appropriate investment strategies would differ fundamentally, depending on which one of the two will prevail.
2. **I think we are presently in the late phase of Scenario 1, and that Scenario 2 will soon follow. While the two scenarios can not exist simultaneously they can be two acts in an unfolding drama. The combination of a credit crunch, an oil price explosion and housing slumps in the US, the UK and in Spain will eventually take its toll. Monetary and fiscal policies will be fairly powerless at that stage.**
3. **So far, the numbers suggest that the world economy is still in rude health**, that overall demand and the rate of capacity utilization remain strong and high, that the world is swamped with liquidity and that inflation, not surprisingly, is on the way up. The message we get from stock markets - and recently also from government bond markets – is that we are experiencing a more or less normal cyclical slowdown which can be managed by central banks. Lower interest rates and a generous supply of liquidity will do the trick. The crisis will thus not get out of hand. Reassuringly, Messrs Bernanke and Trichet have not yet run out of ammunition.
4. Going by their policy statements as well as their actions it is obvious that **central bankers are afraid of a systemic crisis**, especially of an implosion of the world's financial system. Most market participants are convinced that preventing such an outcome has top priority, and that fighting inflation will take a back seat as long as the danger persists. The lesson of Japan's multi-year recession cum deflation is that early expansionary measures and, probably, a stabilization of the exchange rate are needed once major bubbles have burst. Market participants are convinced that policy makers will not repeat Japan's mistakes.

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5. This is the only plausible explanation for the high valuations seen in almost all stock markets. **Investors seem to look through the present period of uncertainty and stagnation of corporate earnings, betting on a new expansion in the not too distant future.** They argue that the US economy is in the process of successfully switching from consumer and housing driven growth to growth stimulated by exports and corporate investment spending. While this causes some frictions and thus a temporary slowdown of the economy, a recession can be avoided.
6. According to this view, **the world outside the US is presently in good shape and thus able to power ahead more or less undisturbed by America's thriving exports and sluggish imports.** Since continental Europe does not suffer from major imbalances – except for Spain's housing bubble, but that is now deflating quickly – and is well behind in the business cycle, there is no reason to be pessimistic about near-term growth there. Household consumption, in particular, will respond vigorously to the employment boom. As usual, Japan will more or less hang in - it benefits from an undervalued exchange rate, low real interest rates and expansionary fiscal policies.
7. **For the optimists, the main driver of world economic growth will be emerging markets** which, in purchasing power terms, account for almost 50 per cent of total output (according to new World Bank calculations, in 2005 their share was actually only 33.7%) . They are financially very sound and will thus not be restrained by restrictive monetary or fiscal policies – they have come off the hook of the IMF during the past ten years. They are also increasingly less dependent on exports to the US as their domestic demand is catching-up quickly. Since it has started from such a low base, the process can be vigorous and last for a long time.
8. **If this is how things will unfold in coming months, it makes sense to assume that commodity prices and inflation in general are not about to slow. Equities are shares in real assets and thus the place to be.** Moreover, investors can be confident that central banks will not tighten the reins too much. The crisis in the financial sector will drag on for the foreseeable future, as write-downs of housing loans and asset backed securities continue to cause losses - which makes interest rate increases a risky policy. In other words, the party can go on, and growth will soon pick up again. Fixed income securities are the obvious losers.
9. **I can not exclude such an outcome. Especially in the near term there is a fairly high probability that this is the story that will drive market movements.** There are indeed hardly any signs so far that economic growth is stalling. But we also know from history that recessions have often been preceded by a benign environment. We also know that both market participants and analysts are notoriously bad in calling cyclical turning points.
10. Most importantly, since GDP growth rates have been high, and real interest rates low, for an unusually long time, the sense of risk has been lost to some extent. This has led to excessive borrowing, excessive asset prices and, more generally, **imbalances. By definition, these cannot persist. The larger they are and the more there are of them, the more likely is it that the adjustment period will be long and costly (in terms of lost potential output).**
11. This is the main point which suggests that the **world economy is not yet out of the woods.** To start with the situation in the United States, the housing bubble has been deflating for more than a year and a half. We are now at a point where the number of unsold homes is so large that house prices will inevitably fall at double digit rates, the first time in decades. Consumers – for

whom real estate is the most important asset – will be shocked by the decline of their net wealth. They are also no longer able to borrow as much against their houses.

12. At the same time, banks have been forced to tighten the standards on consumer loans. **Unless interest rates are cut very aggressively, households must reduce their leverage by spending less and saving more. Increasingly, they have to revert to expensive credit card loans.**
13. **Another factor that is hurting US consumers is inflation.** For them, it is headline, not core inflation that counts. At 4.3% y/y in November, it has become a powerful drag on their purchasing power. The weak dollar and the commodity price boom have resulted in an import price inflation rate of no less than 11.4% y/y. The producer price index is up 7.2%. So there is strong pressure in the inflation pipeline which will keep CPI rates high unless, that is, demand slows a lot.
14. On the other hand, aggregate personal income was 6.0% y/y in October. This means that **real incomes of American consumers was ahead 1.7% y/y. The growth rate of this statistic has been on the way down** for several months as employment growth has been slowing. To give an example: over the past six months, 563,000 jobs were added to the non-farm payrolls, compared to 1,035,000 during the same period one year ago. This looks like a well-established downtrend. At the same time, corporate profits, one of the components of personal income, have declined in the third quarter, for the first time in many years. It looks as if the present quarter will see another, and even steeper, decline. Bottom line: with inflation still rising and personal incomes growing by less and less, a further substantial erosion of purchasing power looks inevitable. **Household consumption will be quite weak in coming quarters.**
15. The hope is that net exports and capital expenditures will increase a lot and fill the gap left by sluggish consumer spending. Not an easy task, given that private consumption accounts for 71% of US GDP! Real exports are already on a fairly steep uptrend - which reflects the weak dollar and the still booming world economy -, while imports are rising much less. In Q3, the seasonally adjusted annualized rates of change were 18.9% and 4.3% respectively. **The reduction of the external deficit in goods and services will continue to contribute positively to US growth.** On recent trends, it will be in the order of (annualized) 0.5 percentage points.
16. One optimistic assumption is obviously that the **rest of the world will accept a corresponding deterioration of its own balance of trade.** It requires a stimulation of domestic demand in Europe, Japan and other East Asia. Policy makers there may be surprised to learn that this would be their part in the overall game plan.
17. **US capital spending is also boosting growth.** Housing, of course, is on the way down, but real non-residential fixed investment (which accounts for 12% of GDP) has been expanding at an annualized of 9.4% in Q3, boosted by strong growth of final demand, high capacity utilization rates and a high level – as opposed to a high growth rate – of corporate earnings. All these supports are presently getting weaker. It is therefore not conceivable that firms will maintain the momentum of their capital spending. After all, there is also a credit crunch.

18. **All this means that the outlook for the US economy is anything but rosy.** A recession is a distinct possibility. Rapid rate cuts by the Fed could turn things around, but high and rising inflation is still a strong deterrent. Core inflation and inflation expectations are both moving in the wrong direction. Another way to prevent a recession would be to boost government spending and to provide tax incentives for households and business. The budget deficit is quite small after the long period of strong growth and permits such a change of direction. Fiscal stimulation will soon move to the top of the policy agenda, but it is doubtful that it can change much, especially not the indebtedness of households and the balance sheet problems of banks which lie at the heart of the US crisis.
19. **Europe, meanwhile, shows no signs of a vigorous revival of domestic demand.** In spite of the strong euro and very moderate wage increases inflation has been rising rapidly. In November it reached 3.1% y/y and thus, incidentally, exceeded its target of a little less than 2% by a big margin. It also exceeded the compensation per employee where the most recent number has been just +1.8% y/y. If it were not for the increase of employment by 1.7% y/y, real labor incomes would be falling. Even so, they are up by only 0.4% y/y. This does not suggest that workers are going on the spending spree that would be needed to absorb part of the reduction of the American trade deficit.
20. **Corporate profits are still booming, which is positive for capital spending.** Perhaps even the appreciation of the euro can be seen in a positive light: in order to maintain international competitiveness, firms must increase their productivity, and the most straightforward way to achieve this is to expand the capital stock. Moreover, the rate of capacity utilization is fairly high after several years of above-average output growth. In October, industrial production was still 3.8% y/y. This also suggests that investment activity should hold up well.
21. **But another obvious problem area, aside from depressed household consumption, could be the foreign sector of the euro area.** So far, the balance of trade has not yet deteriorated. Even in real terms exports are still rising faster than imports (7.4% y/y vs. 6.0% y/y in Q3). This is almost typical for a period where the real effective exchange rate has appreciated a lot (the so-called J-curve effect). The large increase in Europe's relative prices vis-à-vis the rest of the world will eventually have its negative effect on net exports and thus growth. This is one of the reasons why most forecasters have reduced their GDP projections for 2008 to less than 2%, from 2.6% in 2007 - the output gap will thus widen again. This will help to bring down inflation over the course of 2008.
22. **The ECB is not yet ready to cut interest rates, given the inflation target overrun.** Its staff has just produced a new projection which puts the midpoints of the 2008 and 2009 ranges at 2.5% and 1.8% y/y. Some board members actually think these numbers are too low. The central bank is massively injecting temporary liquidity into the financial sector but this is only aimed at preventing a banking crisis, not at stimulating demand. On the other hand, the budget deficit of the government sector is only 0.9% this year, ie significantly below the Maastricht limit of 3%. The public sector will soon be called on to lend some support to a weakening economy.
23. **Japan's economy, meanwhile, is visibly running out of steam,** and some forecasters have begun to talk about the possibility of a recession. After the introduction of new regulations the housing sector seems to be in a free fall. The government expects a GDP growth rate of 1.3% y/y for the fiscal year ending next March, followed by an average of 2% y/y over the next twelve months. Most other analysts think it will be even less. **Deflation has still not ended, in**

**spite of the large devaluation of the yen over the past years (13.5% in trade-weighted terms since the beginning of 2005) and the steep increase of commodity prices.** 10-year government bond yields of 1.5% suggest that investors anticipate not only stable prices but also very slow growth, if not a recession. **Japan will certainly not come to the rescue of the US by turning into a big-time importer. Domestic demand is too weak.**

24. **The biggest contributions to world economic growth and commodity price inflation continue to be made by emerging economies, especially the BRIC countries. But can growth rates accelerate from here?** Industrial production in China is 17.3% y/y, 11.8% in India, 10.3% in Brazil and 6.1% in Russia. India and Brazil have already adopted fairly restrictive monetary policies while China and Russia remain very expansionary. Short-term interest rates there are significantly below the growth rate of nominal GDP. It is likely, though, that from here on the reins will be tightened as well, if only moderately. Inflation is far above target and may become a social problem. As always, it hurts those who are unable to raise their wages or pensions, which is the majority of the population. Even authoritarian regimes must keep their constituencies happy.
25. **In the eastern part of the European Union inflation has accelerated a lot in recent months,** more than in the euro area. Growth has been both higher and more commodity intensive. Hungary is somewhat of an exception. But on balance, the loss of purchasing power caused by higher-than-expected inflation will reduce the year-on-year growth rate of GDP from about 6% this year to a little over 5%. The region is still powering ahead, driven by the integration into the EU, generous support from Brussels and large foreign direct investment, which in turn is attracted by low costs, buoyant domestic demand and a huge potential for catching up with the West. **But at least temporarily, the momentum will slow.**
26. **All of the above implies that the commodity boom will take some time out** – before it takes off again. Prices are still very elevated, and have increased several times faster than the world's nominal GDP over the past four years. Oil prices have peaked in late November at close to \$100 and are now drifting down. Metal prices had reached their peaks half a year or even a year ago. How far they will fall from here depends on the extent of the slowdown of world demand, in particular whether Scenario 1 will prevail or not. If it does, and is not followed by Scenario 2, the prospect of accelerating inflation will quickly drive up commodity prices beyond their earlier highs. Commodities are inflation hedges, after all.
27. **So it will all depend on how severe the US slowdown turns out to be. It is important to watch how American consumers react to falling house prices, tighter lending standards, the loss of purchasing power and the deterioration of the labor market.** They are usually more resilient than one would think. The rest of the world is more predictable – it seems more or less certain that there will be a loss of growth momentum. Purchasing power is suffering from rising inflation, and exports to the US will weaken. Strange that the credit crunch has not yet been reflected in slower credit growth. Is the credit crunch only a problem inside the financial sector? So far it looks that way.
28. As I argued above, **the unwinding of the housing bubbles, excessive borrowing and the imbalances in current accounts carries significant risks. We are at the end of one of the longest expansions of the world economy. At some point, recessions cannot be avoided,** simply because the returns on investment, ie the rate of growth of corporate earnings will suffer from overinvestment, or a wrong allocation of resources. Leverage is usually highest toward

the end of a cycle and has to be reduced as expected risk-adjusted returns are revised down and fall below the cost of funding. However, since I tend to predict more crises and recessions than actually occur, I must warn the reader that I may once again be too bearish. Remember, though, how long the state of denial had lasted in Japan in the early nineties.

29. **In a situation where one does not know for certain whether we are heading toward higher inflation and growth or toward lower growth and lower inflation, the safest bet is to be in high quality/short duration bonds, such as 2-year US Treasuries or German government debt. Reasonably valued equities of emerging markets with favorable GDP growth prospects and appreciating currencies should also play a major role in today's portfolios. Exporters from the OECD area which are successful in emerging markets are another plausible bet. It does not make much sense, though, to be long commodities – if the pendulum swings toward deflation after all, they are in for a crash. Corporate bonds, most banks, most real estate stocks are too risky for my taste at this juncture.**
30. **How about currencies?** Intuitively, the **yen looks very cheap**, given its big depreciation and Japan's huge current account surplus. As other countries cut interest rates, the rate disadvantage will shrink. **The dollar** is correcting since the day the Economist carried a cover picture showing it to be in a free fall. So far, the correction has been orderly. Keep in mind, though, that the Fed is likely to continue cutting rates, and that the improvement of the US balance of trade may come to a halt as the world economy slows and the price competitiveness of US products suffers from the dollar appreciation. Under normal circumstances, **sterling should be depreciating**: the Bank of England will cut rates in response to the banking crisis and the cooling of demand in the wake of the deflation of the housing bubble, and both the budget and the current account deficit are very large. Whether **commodity currencies** such as the rouble, the Australian dollar or the South African rand will remain strong depends, of course, on commodity prices. The rand is, for several reasons, most in danger of depreciating, followed by the Aussie dollar, while the rouble looks rather solid. In order to bring Russian inflation down, a stronger appreciation and a reduction of dollar and euro purchases by the central bank would be helpful.

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