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Wermuth's
Investment Outlook

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1. **I remain confused**: can it be that America's economy grinds to a halt while at the same time commodity prices break one record after another? Why are government bond yields falling when inflation is on the way up (globally, it has about doubled over the past year!)? Expected inflation, an even more important driver of bond yields, is everywhere on the way up as well. The pick-up in inflation is seemingly not regarded as a blip. Gold, the classical inflation hedge is getting more expensive by the day. At the same time, even those government bonds which do not provide protection against an acceleration of inflation, are also in strong demand. Stock markets are weak, and so are almost all housing markets, with the exception of those in emerging countries. **Market participants are de facto predicting falling profits and slower economic growth.**

2. **This is the opposite of what commodity prices are telling us.** Central banks outside the US and the UK are more worried about inflation than about growth and have either maintained or adopted tightening biases. World economic growth is expected to slow further, but it is still so strong that the issue for these central banks is capacity constraints and rising inflation, not rising unemployment. Capital spending is robust, but not robust enough to get supply in line with demand.

3. **The picture is only consistent under the assumption that US developments do not matter much any more for the world economy as a whole.** This would be quite a change from the past when global business cycles were dominated by America. Is this plausible? Why should things have changed so suddenly? The weight of the US economy may have declined, but on the basis of current exchange rates it is still 26.2% ($14tr, compared to a world GDP of $53.4tr, in 2007). Even if we use the World Bank's new purchasing power parities as weights America's share is still about 22%.

4. That the rest of the world, and commodity markets in particular, should be so little impressed by the prospect that US growth will be down to 1% to 1 ½% y/y in 2008, from 2.2% in 2007 and 2.9% in 2006, could also reflect the **expectation that anti-cyclical monetary and fiscal policies will succeed** to push the US economy quickly back onto its medium-term grow path of 2 ¾%.

5. **Last time the US slowed, from 3.7% y/y in 2000 to 0.8% 2001, the effects on the rest of the world were actually quite dramatic.** World output growth declined from 4.8% y/y to 2.5%, the volume of trade in goods and services from 12.2% y/y to 0.2%, and dollar prices of oil, metals and agricultural raw materials all fell.

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6. **This time around the reduction of US output growth is generally forecast to be milder, but I wonder whether this is mostly wishful thinking.** The present slowdown may turn out to be just as severe as last time. There is now a serious oil crisis which continues to erode the purchasing power of households, employment grows by less than the labor force, and borrowing has become difficult as banks worry about the quality of their assets and their own ability to attract funding.

7. **Moreover, the wealth effect of the ongoing decline of US house prices is likely to be massive.** Before the crisis the net market value of the real estate stock was in the order of $22tr. House prices have fallen by 10.5% since July 2006, but will probably come down by another 10% given that the amount of unsold homes is still at a record high and that securitizing mortgages has become difficult. The price decline translates into a reduction of book values by $4.7tr, or about 40% of annual personal income.

8. It also means that the **collateral for household loans is shrinking**. On March 7, the Wall Street Journal commented that "the downturn in homeowners' equity has accelerated, and it is being driven by falling home prices, which is more ominous both for consumers' net worth and for the loans collateralized by those homes. The decline could portend an increase in the delinquencies and foreclosures that have roiled global credit markets."

9. Worst off are those first-time home buyers who had borrowed up to 100% of the purchase price – they now have negative net equity. **The real estate situation resembles very much the one in Japan in the nineties** – there it was the main reason for the decade-long belt tightening of overindebted consumers, deflation and disappointing economic growth. Deleveraging is always top of the agenda once an asset price bubble has popped.

10. **The value of equity portfolios is also shrinking rapidly** as US stock markets are on a well-established downtrend. Corporate earnings are likely to decline further. In a recession, anything else would be very surprising indeed. This aggravates the wealth effect of falling house prices.

11. To make matters worse, US consumers are hit hard by inflation these days. In the six months through January, prices rose by 2.4% while incomes were up only 2.1%. Will consumers finally throw in the towel? Another problem: for many years, changes in the terms of trade had allowed households to spend more than they produced. This is no longer the case. In January, US export prices were 6.7% y/y but import price inflation was no less than 13.7%. **For consumers as a group, it is no longer possible to live happily beyond their means. The opposite is the case.**

12. There are, in the meantime, **powerful countervailing forces** at work. **One is the weak dollar.** In trade-weighted terms, the greenback has lost 13.1% over the past year, and the price competitiveness of American industry has improved correspondingly. Real exports of goods and services were up 7.9% y/y in Q4 while imports were only plus 0.9%. Net exports have been the main driver of US growth last year, ahead of non-residential fixed investment. This will continue for the foreseeable future. Given that household spending accounts for 72% of GDP, net exports have to grow very strongly to compensate for the weakness of private consumption. It will probably not work.

13. Low interest rates also help. **The Fed has responded early and massively** to signs that the US economy might be heading for a recession. Since September, the funds rate has been cut from 5.25% to 3%, and could reach 2% by the meeting on March 18. Liquidity to the banking sector has been provided generously and on increasingly easy terms. All borrowers whose debt is on adjustable rates have gained a lot, in spite of lenders' increased risk aversion and thus of rising spreads.

14. In real terms, on the basis of inflation expectations, short-term rates will soon be in negative territory again. The Fed has to make sure that the **slope of the dollar yield curve remains positive and steep for a long time.** Borrowing short and lending long will once again be the main source of banks' income, rather than trading and securitization. The equity base must be rebuilt, and raising money from foreign sovereign wealth funds is already running into political obstacles.

15. Cutting the funds rate is a necessary but not a sufficient condition for turning the economy around. The decline in asset values has led to a general deterioration of debt ratios. **Deleveraging, ie the reduction of debt levels via a reduction of spending, is therefore the order of the day.** Banks, meanwhile, have to shrink their assets and are more reluctant to lend. In such a situation, interest rate incentives help only at the margin, as the Japanese example has shown. More worryingly, interest rates are fast approaching zero, the area where this tool loses its effectiveness.

16. **US fiscal policies are increasingly expansionary which is another necessary condition for the stabilization of overall demand.** This also reminds me of Japan where at some point the government budget deficit had reached 8% of GDP. It did not help much in the near term because deleveraging was a very lengthy affair. Without the massive fiscal stimulus the loss of output would have been even larger, though.

17. I think I am on the safe side if I say that **the US recession is well under way** by now. Employment is falling, more and more people are leaving the labor force, and industrial production has been stagnating for six months. Since this is not a recession which can be overcome by simply stimulating demand, it **will probably last longer than most market participants assume.**

18. This implies that the **decline of the dollar will continue**. America's current account deficit is still expected to be in the order of 4.7% of GDP this year. Since there are so many dollars around already, it is not so easy any more to attract the necessary capital imports. One obvious way to achieve this is to lower the prices of US assets such as real estate and stocks, and a further depreciation of the dollar.

19. If interest rates are pushed close to zero, it can be expected that **dollar carry trades will become popular** (presently, yen and Swiss franc carry trades are being unwound which is one reason for the momentum of the yen and SFR appreciations). The US administration seems to welcome these prospects. Talk of the desirability of a stronger dollar is just talk.

20. These processes are well under way but have still some time to run, it seems to me. I would **not be surprised to see the S&P 500 fall to 1150, and the euro rise to $1.70 in this business cycle.**

21. On the other hand, **yields of US Treasuries will decline further, for three main reasons**: 1. the prospect of an even lower Federal funds rate, ie the ongoing reduction of the cost of carry caused by the decline of short-term rates, 2. the good standing of the borrower, and 3. the liquidity of the instruments. The reduction of the rate of inflation over the course of the recession will not be the most important driver of yields, at least for the time being. **Progress on the inflation front will be kept back by sticky inflation and inflation expectations.**

22. One reason is that wages which are a lagging indicator in any business cycle are still rising at an annual rate of 3.7% (in February). As mentioned earlier, import prices were 13.7% y/y in January; producer prices were 7.4% y/y that month. There is **a lot of pressure in the inflation pipeline**.

23. Investors in TIPS (Treasury Inflation-Protected Securities) are actually of the opinion that Mr. Bernanke is more intent on spurring growth than on restraining inflation. Since February 29, **5-year TIPS trade at a negative yield**, for the first time ever. In order to get protection against inflation investors are willing to accept a negative real yield. Even so, I expect yields of normal (unprotected) 10-year Treasuries to fall below 3% in a year or two. Readers will recall that Japan's 10-year government bond yields had dropped to 0.56% at one point!

24. **The question is: will the rest of the world economy continue to boom regardless of what happens in the US?** Commodity prices seem to suggest this. Can we really expect that America's problems are no more than an irritant in the scheme of things? **I have my doubts.** One defining feature of today's global economy is that it more and more resembles a domestic economy, a result of the ongoing breakdown of barriers to trade and capital flows, and the dramatic reduction of communication and transportation costs. There are numerous channels through which US developments have an impact on other economies.

25. **In the euro area, whose nominal GDP will exceed America's once the euro passes $1.57, things are deteriorating gradually, but there is no sense of panic yet.** Major imbalances are lacking, such as current account deficits or asset price bubbles which might cause problems when they burst. The ECB has reduced its forecast of 2008 real GDP growth to 1.7% y/y last Thursday which means a falling rate of capacity utilization. Employment growth, one of the success stories of recent years, will probably slow to less than 1% - the last reading had been 1.9% y/y. So far the consensus is: slower growth: yes, recession: no.

26. **For the euro region as a whole house price deflation is not an issue.** There had been bubbles in Spain and (tiny) Ireland, which are now deflating, but average residential property prices had increased only by a fairly modest 6.7% annually over the past four years. Prices were still up 5% y/y in 2007; they may stagnate or fall slightly from here on.

27. **Stock markets are weak** these days, weaker even than those of the US which they had outperformed last year. Stock markets are closely linked internationally – as America gets cheaper relative stock prices in other countries rise, which in turn tends to trigger some off-loading. Overall, Euro area asset prices are probably a slight drag on demand and GDP growth.

28. A number of euro area banks which had been seduced by the high yield and supposedly good quality of US asset backed securities have suffered large losses and had to be rescued one way or another. So the **US subprime crisis has indeed spilt over into markets this side of the Atlantic, and there is now a banking crisis** which has forced the ECB to substantially increase its refinancing operations. In spite of this, the 3-month Euribor rate is no less than 60 basis points above the ECB's main refinancing rate; in more normal times the spread is 15 to 20 basis points.

29. **Another sign of the problems in the sector is the unusually wide spread of 52 bp of 10-year swap rates over 10-year Bunds,** the euro area's benchmark for government bonds. Corporate bond spreads which had been almost ridiculously low until last summer, are quite wide these days. Borrowing conditions in general have tightened considerably. That lending to the private sector was still up 11.1% y/y in January reflects the difficulty of borrowers to raise funds on capital markets which have become very risk averse. So they are asking, in the old-fashioned way, their banks for loans again. **On balance, the problems of the financial sector are one of the reasons for the likely reduction of euro area growth.**

30. Exports to the US are down steeply (for Germany -15.9% y/y in Nov/Dec), but imports from the US are also declining a lot (Germany: -12.5% y/y in Nov/Dec). So **there are some effects on trade from the weak dollar and the slowdown of growth in the US, but overall they are modest.** The area's bilateral current account surplus with the US is still substantial (0.4% of GDP). Weaker trade numbers with the US are more than compensated by booming exports to Eastern Europe and Asia. Net exports are still the major contributor to euroland GDP growth. The strong euro is not yet a problem (Mr. Trichet doesn`t seem to be so sure any more).

31. **Europe's weak spot remains private consumption which has suffered from the near-stagnation of real household incomes and is now hit hard by the explosion of oil and agricultural prices.** On March 4 the Economist commodity-price index which includes food and industrials, was +45.0% y/y in dollar terms, and 24.0% in euro terms. The dollar oil price of West Texas Intermediate was up 64.6% y/y, or 40.8% in euros. While the euro appreciation has served as a cushion, the impact of commodities on prices in general is still very strong.

32. Headline inflation has been 3.2% y/y in both January and February and thus not only far above the ECB's target but also about one half to one percentage point above the growth rate of household incomes. Since employment growth will probably slow from now on, **the outlook for household consumption is deteriorating.**

33. The ECB worries about **downside risks** to its forecasts and mentions the banking crisis, commodity prices, increasing protectionism, and the strong euro. Compared to the upside risks to price stability, they are, in its view, **still of secondary importance**. First things first – for the ECB price stability has priority. Mr. Trichet does not concur with rate predictions derived from yield curves. These call for rate reductions of more than 75 basis points between now and the end of the year, ie to less than 3.25%. As long as hard economic data do not indicate that a genuine recession is near, the ECB will sit tight.

34. **Germany's statistics in particular continue to surprise on the upside.** In the three months to January, real incoming orders to the manufacturing industry were +11.2% y/y, and 16.1% annualized (saar) over the preceding three months. Foreign orders were particularly strong, and real exports are rising fast while real imports are stagnating. Net exports will therefore remain a major contributor to overall growth. Industrial production is sort of booming – in the three months to January it exceeded its average year-ago level by 6.2% y/y. The unemployment rate falls month after month and has reached 8.0% in February (s.a.), after 11.4% just two years ago. Surveys are weakening but still suggest that fairly brisk growth may lie ahead. Were it not for the reluctant consumers!

35. **In trade-weighted terms, the euro has appreciated 8.0% over the past year**. This is much less than against dollar and pound sterling. It reflects the weakness of the euro against yen and Swiss franc, and its relatively modest appreciation against the currencies of most emerging economies whose weight in the euro's trade-weighted basket continues to increase.

36. **Euro area assets have safe haven properties these days.** The euro is appreciating, the ECB will not cut rates before the summer (in spite of the appreciation of the euro), inflation has probably peaked, growth is steady if sub-par, real and nominal bond yields are considerably higher than in the US, corporate earnings will either increase slightly or stagnate this year, and stock market valuations are attractive. Trailing price-to-earnings ratios are 10 to 11 for the major indices and thus well below the S&P 500's p/e ratio of 19. On a forward basis, the valuation difference is at least as large, as earnings of euro area corporations will probably hold up quite well. The risk of a recession is limited.

37. **Yield spreads between euro area government bonds have widened** dramatically in recent months. In the 10-year range, Italian bonds yield no less than 60 basis more than Bunds whose yield to maturity is at 3.81%. Since Italy is presently in an economic and political crisis, investors think that the likelihood of it leaving the currency union at some point has increased a lot. They are certainly wrong because the cost of quitting far exceeds the benefits – and would not solve the country's structural problems. **This suggests to be short Bunds and long Italian government bonds.** That the spread of France over Germany is now 19 basis points is equally surprising. It shows that Monsieur Sarkozy's attempts to gain more control over the ECB have been counterproductive, like a shot in the foot. In the long run, the usual spread of less than 10 basis points will re-establish itself.

38. **Central Europe, dominated by the economies of Poland, the Czech republic, Hungary and Slovakia, will suffer somewhat from the US recession and the euro area slowdown, but domestic demand remains so strong that real GDP growth will still be 5.0% y/y in 2008**, after 5.9% last year. The region (which is part of the EU but not the euro area) benefits from low cost levels, transfers from Brussels, large private capital inflows and the rapid growth of the capital stock.

39. The currencies of these countries have not only appreciated against the dollar, but also against the euro (with the exception of Hungary). This helps to keep inflation down. The main exports are cars which are rather cyclical products and will suffer should the euro area stall in coming quarters. This is less of a risk than it sounds because domestic demand is very dynamic and has become the main growth engine by now. **On balance, the region contributes to commodity price inflation, and it also exports inflation (currency appreciation plus domestic inflation in the order of 6% y/y).**

40. **Russia, meanwhile, continues to profit from the commodity price inflation**, but since its nominal GDP is expanding at rates of about 20%, it is also contributing to that inflation. The financial crisis in the US has had some negative repercussions. It had been very attractive to borrow in the dollar market, because interest rates were low, and the rouble had appreciated against the dollar year after year. This window is now partly shut which explains the weakness of Russian bank stocks.

41. The Russian stock market has traditionally been highly correlated with US markets which are the world's largest and most liquid. **In the near term, the weakness of US stocks will therefore have negative effects on Russia.** In addition, the US recession will have a negative impact via the weakening of demand for commodities and energy.

42. For now, **Russia is still in a sweet spot.** In the wake of the latest commodity price inflation, export revenues have been up an astonishing 42.8% y/y in dollar terms (Dec/Jan) and are running at an annual rate of $430bn, the equivalent of 31% of 2007 GDP (at today's exchange rate of RUB 23.87 to the dollar). Imports are also booming if by less (37.7%). This means that the balance of trade surplus continues to widen: on present trends, it will reach 15% of GDP this year.

43. It can be assumed that Russian export prices are up about 30% y/y while import prices may be rising at rates of 5 to 10% y/y. The implication is that real imports are rising much faster than real exports, and **foreign trade is thus a large drag on growth**. Russia exports mainly commodities and energy, some bulk manufactured goods and arms, and it has become hooked on importing all other goods.

44. **Russia's domestic demand more than compensates for the weakness in real net exports.** There is a lot of liquidity - generated by FX market interventions -, employment is rising briskly, real wages are increasing by more than 10% year-over-year, and interest rates are relatively low (in any case much lower than the growth rate of nominal GDP which was 22.7% y/y in Q3). While real government spending had been up only 3.1% y/y, private consumption was no less than 12.8% y/y.

45. **Capital expenditures also made a large contribution to growth (+17.5% y/y).** On the output side, the strongest sectors were construction, retail sales, hotels, financial services and real estate, all with double digit growth rates, while agriculture, mining (!), electricity generation, education and health were all growing by hardly more than zero percent. Growth is very uneven. But overall, Russia is one of the world's main growth engines.

46. It is no wonder that **inflation is getting out of control**. In February CPI had been 12.7% y/y, and January's PPI was 25.2%. Civil servants and pensioners who live on fixed incomes are the main victims. Since employment growth is still brisk, high inflation is not yet a risk for the political stability of the country. This may change should commodity prices and thus the terms of trade collapse one day. For now, living is easy.

47. I would also argue that **the government has the financial means to stimulate the economy in case household incomes decline one day**, at least for a while. At almost $500bn, foreign exchange reserves are the world's third largest and thus a thick cushion.

48. I would be more optimistic about Russia's economic future, though, if the national investment ratio could be lifted from its disappointingly low 20.2%. It compares unfavorably with China's. **High inflation is like poison for household savings and thus capital spending.** The easiest way to solve this problem would be to stop intervening in foreign exchange markets, ie let the rouble appreciate by more.

49. This will happen in the not so distant future. The fact that rouble denominated one to three year corporate and municipal **bonds yield only between 6 and 9 ½%,** well below inflation, suggests that markets are actually betting on a stronger rouble (only a few government bonds have a duration of more than five years).

50. **Are Russian equities still a good buy?** The trailing p/e ratio for the blue chip RTSI$ is 11.2 which is not really cheap any more. The index has benefited from the much improved liquidity of the 50 names it contains, and the expectation that Russia would to some extent be insulated from the fall-out from America's deflating asset price bubbles, and provide some hedge against inflation. By now, investors should pay more attention to less transparent and liquid second and third tier stocks, including private equity type investments in real estate. Stock picking will yield better returns than macro plays.

51. **Japan is directly affected by the recession in the US.** The falling Fed funds rate and the deteriorating outlook for corporate earnings and stock prices have led to a massive **unwinding of the so-called yen carry trades**, ie the borrowing of yen for investments in higher-yielding foreign assets, especially in the US. Since its peak of 124 yen in the middle of 2007 the dollar has moved to below 102 yen today; the yen has thus gained of 21.7% against the dollar. In trade-weighted terms, the yen appreciation has been a more modest 5.9% y/y because the value of other currencies which are part of the basket, such as the euro and the renminbi, has also increased relative to the dollar.

52. As was to be expected, **Japanese firms are cutting back on capex**, in spite of strong demand for their products from neighboring Asian countries and a favorable product mix. In general, international price competitiveness is still good considering that the yen is not nearly as expensive as it used to be during the nineties when, at some point, it rose to 80.63 against the dollar (April 18, 1995).

53. Because of the strong yen, export prices fell by 5.7% y/y in January while import prices were still up 6.8% y/y, reflecting the commodity price explosion. This is **bad news for corporate profits**. JPMorgan forecasts that real business investment will be only 0.1% y/y in 2008. The steep decline of the stock market - 17% year to date – is another reason why firms are hesitant about expanding capacity. The cost of raising equity has shot up correspondingly.

54. **Japanese consumers, meanwhile, are doing somewhat better.** As in the euro area, only more so, weakness of the household sector has been a persistent cause of worry. But now (core) wages, typically a lagging indicator in the business cycle, are rising at rates of about 2% and thus faster than inflation (0.7% y/y); employment is also increasing (0.8% y/y). This is good news. The question is how long this will last. Headwinds are obviously very strong and could become even stronger - there are no signs that the yen appreciation has run its course.

55. **Deflation remains a risk after all these years. 10-year JGBs yield only 1.32%, or 30 basis points less than one year ago**. The Bank of Japan which would like to "normalize" interest rates is once again in a bind. With real GDP growth probably not more than 1% y/y in 2008, and the rising yen the equivalent to a significant monetary tightening, higher interest rates probably have to wait until 2009. Because of this, and in view of the strength of the yen, Japanese government bonds are more attractive than they look. Stocks are not expensive either, if only in relative terms.

56. **China continues to boom**: real GDP was +11.2% y/y in Q4, industrial production +17.4% y/y in December. According to the IMF, 20% of last year's increase of global output came from China – in purchasing power terms, the contribution was no less than 26%. Output growth has accelerated almost year after year since the late nineties when the growth rate was around 8% annually.

57. Faster growth was until recently accompanied by falling and very low inflation. **CPI** had come down from 28% in 1993 to a range of -2% to +5% between 1998 and 2006. Since the middle of 2006 it has started to take off from 2% to presently **8.7% y/y**. Producer prices had mostly declined during the long period of de facto price stability as productivity increased in leaps and bounds on the back of an unprecedented investment boom. **Between 1993 and 2006 real capital expenditures rose by an average annual rate of 15.9% which drove the investment ratio from an already high 36.0% to 40.8%.** Wages and household incomes were rising at lower rates, but since a rising tide lifts all boats, the average standard of living has also improved dramatically.

58. **China's monetary policies are still very accommodative**: money supply is rising by about 20% y/y, and real deposit rates are negative and far below the growth rate of nominal GDP. The government is concerned that growth will slow and cause social unrest. The income distribution of this communist country is one of the most uneven in the world. It is therefore rather unlikely that truly restrictive policies will be adopted.

59. The most plausible strategy at this point is to allow the renminbi to appreciate faster – which is happening. Even so, the **currency is significantly undervalued**, and the current account surplus is still about 11% of GDP. It is one of today's inconsistencies that one of the poorest countries is also one of the largest capital exporters, comparable, in relative terms, to Switzerland, Singapore, Holland and Norway, and in absolute terms to Japan and Germany.

60. One problem in China is that private capital exports are still rather restricted which has led to a large increase in the demand for domestic assets such as real estate and equities. **Bubbles have developed.** The stock market had been extremely overpriced until recently and is now correcting. The housing market could be the next to follow. Much reminds me of the situation in Japan at the end of the eighties.

61. For the time being, **Chinese demand is the main driver of most commodity prices**. The country is in full catching-up mode, and has no serious financial constraints, nor is it in any way dependent on the IMF and its recipes for balanced growth. Foreign exchange reserves are in the order of $1.4tr. The expansion is driven from the supply side, and the focus is on products rather than services, all of which are energy and commodity intensive.

62. **Should China's economy slow at some point, a major correction of steel, coal, oil, copper prices and so on would be inevitable.** Triggers for a correction could be the popping of asset prices, the sudden stagnation of exports to the US which account for 31% of all exports, a banking crisis, or much tighter monetary policies as inflation gets out of control. Recall that the typical 19th century recession followed an exuberant expansion of capital spending, ie overinvestment - which then led to disappointing profits and efforts to reduce debt.

63. **It is hard to say how realistic a Chinese implosion is, and when it might occur.** It is clear that the demand for commodities from the US, Japan, but also from Western Europe is weakening. This is still the larger part of the world economy. It is also clear that global GDP growth will at least be one and a half percentage points less than in 2007. In other words, it is rather strange that commodity prices are breaking records at this particular juncture. Some irrational forces must be at work. The main explanation is that inflation will increase further, and that **commodities are regarded as inflation hedges.**

64. **The verdict is indeed still out which way the world economy is moving**. Base money growth is still rapid, many large countries are pursuing expansionary policies, such as Russia and China, others such as the US have just joined them, and even the ECB may soon follow suit by cutting rates as the euro appreciation becomes excessive.

65. **But I doubt that inflation will indeed accelerate much further. High commodity prices act as a break on demand everywhere. In the past, oil crises have always been followed by recessions – and by a reduction of wage and price inflation.**

66. This time we are faced with **the additional substantial risks** of house price deflations in the US, in the UK, in Spain, perhaps soon in China, of downward corporate earnings revisions everywhere, accompanied by large stock market corrections, plus a veritable global crisis in the financial sector. Deleveraging has priority for the banking sectors of many countries, for a large part of the hedge fund and private equity industries, as well as for those American and other households who had bet on ever-rising real estate prices and forgot to save.

67. **No, slower growth and deleveraging will be the main features of the global economy in coming quarters, not rising inflation. Commodities should be shorted.**