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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

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1. **Global recession or not?** In its new World Economic Outlook the IMF predicts that the world's real GDP will expand by 3.7% in 2008 and 2009, after 4.9% last year. This certainly looks pretty strong. But the authors also see a 25% probability that growth will slip to 3% or less both this year and next – which, according to the IMF, would be the equivalent of a global recession (p. XV). For markets it makes a big difference whether the world economy just slips a little below its medium-term growth rate or actually falls into a recession.

2. **Why should 3% global growth be called a recession?** In the so-called advanced economies, people would be happy about 2 ½% - this is the trend growth rate of potential GDP in the OECD. For the world economy as a whole, trend growth has accelerated from 2.9% annually during the nineties to 4.1% so far this decade.

3. Here is why: global GDP per worker, ie productivity, presently increases at a steady annual rate of about 3%. Should GDP, or demand, therefore rise by only 3% as well, it is inevitable that the number of employed workers would stagnate, and unemployment would rise, given the on-going growth of the world's labor force. **At GDP growth rates of 3% or less we get an increase in the so-called output gap.** Potential supply rises faster than demand – there will be idle capacities. **If the output gap becomes significant, it is called a recession.** Incidentally, Americans define a recession as two consecutive quarters of negative GDP growth. Under this definition the world economy has never been in one for the past 70 years.

4. **It is the increasing weight of relatively poor but rapidly expanding economies such as China, India, Brazil and Russia which has pushed up global trend growth.** In purchasing power parity (PPP) terms, they account for 43.6% of world GDP, and they have been growing at an average rate of 6.4% since 2000 (pp 235 & 241). The process is still in full swing. In ten years' time, their share in global output will be 53% if recent trends continue. These countries are catching up so fast with the developed West because they have plenty of surplus labor, plenty of scope for productivity gains as they adopt modern technology and methods, and because they save and invest a lot.

5. **Market participants seem to agree with the up-beat mainline scenario of the IMF: commodity prices are holding up at all-time highs, bond yields are rising (which suggests that inflation, not growth, is the main concern), while stock markets have rebounded after their steep decline in January.**

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6. **The question is whether it is reasonable to assume that the momentum of the emerging economies is strong enough to make up for the recession in the US and the likely slow-down in other OECD countries.** Does domestic demand in China, India and others already play such an important role that these countries have de facto emancipated themselves from developments in the richer parts of the world? They are certainly no longer dependent on capital imports, but merchandise exports have so far been a main driver of their expansion. Since their net exports will inevitably suffer as the US successfully reduces its balance of trade deficit their other demand components have to expand very strongly indeed to maintain the growth rate of global demand.

7. I **have my doubts. One reason is that emerging economies that are not net exporters of energy, metals and agricultural products are already suffering from the explosion of commodity prices.** The world's annual oil bill alone will be $3.8tr, up from about half as much one year ago, if a barrel continues to cost about $120. To put this into perspective: according to the IMF (p. 241), world GDP at actual, rather than PPP-exchange rates will be $60.1tr in 2008. Oil is just one negative factor, if the most important one: prices of imported coal, gas, iron ore and food have also shot up. This means that the purchasing power of emerging markets has declined accordingly; it is hard to imagine that their domestic demand will not take a hit.

8. **Emerging economies have another serious problem: inflation.** Monetary policies are therefore tightened, and exchange rates are allowed to appreciate more rapidly against the dollar. It is not just prices of imported commodities that are driving inflation, the long period of above-trend economic growth has also reduced spare capacities, a situation where it becomes invariably easier to push through higher wages and prices - which is could trigger a wage/price spiral.

9. In addition to that, some countries, most importantly China, have experienced bubbles in the markets for real estate and equities. In response to higher interest rates and reduced earnings expectations these have begun to deflate which in turn causes **negative wealth effects**, ie cutbacks in consumption and capital expenditures.

10. **The beneficiaries of the commodity price boom** have been the countries of the Middle East, Russia, Nigeria, South Africa, Brazil, Venezuela, but also Australia, Canada and Norway. Their terms of trade have greatly improved – which is equivalent to saying that their purchasing power has been boosted. They have mostly embarked on consumption and importing sprees and are thus supporting economic activity in the less fortunate commodity importing countries, including the US, Western Europe, China and India.

11. On the other hand, the appreciation of their real exchange rates (which is almost synonymous to an improvement of their terms of trade) has caused serious problems in those parts of their economies which are exposed to international competition. They have caught the **Dutch disease.** One effect of this is that domestic output growth is held back: a rising share of demand is covered by imports (whose relative prices are falling). Those sectors which do not compete with foreigners tend to boom, though, such as real estate and all sorts of services and protected industries.

12. **On balance, developing and emerging economies are unlikely to provide the strong support for the advanced economies that the IMF is assuming.** The population of the net commodity importing countries is about three times larger than that of the net exporters. This means the loss of purchasing power in the first group can not be compensated by additional spending in the second group. The world's savings rate will rise.

13. Moreover, they all suffer from the decline in real net exports caused by their strong exchange rates and weak demand in advanced economies. Their growth rate is therefore likely to fall by more than those 1.2 percentage points predicted by the IMF (from 7.9% y/y in 2007 to 6.7% in 2008).

14. **I am therefore convinced that the probability of global growth slowing to less than 3% is greater than the IMF's 25% mentioned above.** I remain puzzled by the prediction that the present slowdown should push global GDP growth this year and next just 0.35 percentage points (pp) below its 4.1% trend line. In similar cyclical situations in past decades, gaps between actual and trend growth rates used to be much larger: 1.0 pp in 1974/75, 1.8 pp in 1980/82, 1.7 pp in 1991/93, and 1.4 pp in 2001/02.

15. **The IMF's optimism can only be justified under the assumption that the world economy is expanding in a very balanced way. But the reality is quite different:**

    - The US, still the number one economy and the second largest importer (euroland is 10% bigger), is in the early stages of a recession; this has significant negative effects on other countries; in January and February US real imports were just 1.8% y/y while real exports were up no less than 13.2% y/y; note that in the past, **all global recessions were accompanied by US recessions.**

    - A serious and hard-to-control **financial crisis** is still unfolding; de-leveraging of bank balance sheets in OECD countries and elsewhere continues; risk aversion has risen, reflected in tight lending standards and wide interest rate spreads between government and private sector debt.

    - Several **housing bubbles have popped** or are coming to that point, including the US, Spain, the UK, to some extent Italy, France and Holland, perhaps China; in general, housing cycles are highly correlated with overall business cycles.

    - **Current account imbalances still need to be unwound**; even in relative terms, they are of unprecedented size; the US, one of the richest countries, has a huge deficit, while China, one of the poorest, has an equally huge surplus; this requires further exchange rate adjustments.

    - The world economy experiences the **most serious commodity crisis for decades**; the international income distribution between commodity exporters and importers is changing rapidly, causing a fundamental re-adjustment of trade and capital flows.

16. In other words, we face an unprecedented combination of adverse cyclical and structural factors. The world economy will not get by with some well-timed anti-cyclical policies.

17. **What does all this mean for markets?** To **start, as usual, with the US**: as the housing, banking and oil crises continue, domestic demand suffers. Corporate profits which have already been falling since the second half of last year, will decline by another 10 or 15%, for a total of about 25%, as in previous recessions. For the stock market as a whole, this is bad news. It would be reassuring for investors if an early end of the recession were likely. It is not. The debate is now whether the recession will be V-shaped (unlikely, I think) or U-shaped (more likely) or even L-shaped (catastrophic).

18. The relatively good performance of US stock markets this year reflects the **expectation that aggressive fiscal and monetary policies will keep the recession short and shallow.** The weak dollar is another stabilizing factor. First quarter GDP numbers, out today, will probably confirm the view that things are really not as bad as they are often made to be. Looking ahead, stocks of exporting companies and multi-nationals with strong foreign earnings will do better than those of companies catering to the increasingly distressed consumer. Banks and other financials are not out of the woods yet, it seems, while the housing sector – which on some measures has declined by more than 50% already – may be bottoming out.

19. Bloomberg's page WPE which lists price-to-earnings ratios provides impressive evidence that **US stock markets must be driven by a lot of wishful thinking.** For the S&P 500, the ratio of 4-quarter-trailing p/e (of 22.1) to the estimated current year p/e (of 15.0, ie 1.473) means that contributors to the page are forecasting that per-share earnings will rise by no less than 47% this year. The p/e ratio calculated on the basis of next year's expected earnings is 12.8, which translates into another increase of profits, this time by 17%. Investment strategies based on such numbers cannot work.

20. At 4.0% y/y, consumer price inflation is too high for the Fed. **Rates will be cut to 2% today, but then it will be time-out for a while.** The monetary stimulus is very strong already. Given the normal time lags between policy measures and their effects on the real economy, it makes sense to take a wait-and-see attitude. The Fed is also increasingly worried about the large and persistent discrepancy between headline and core inflation.

21. Even so, it is fairly certain that **US inflation will soon retreat**. While import prices are rising at double digit rates under the impact of a weak exchange rate and the commodity price boom, wages, the key cost component, remain well-contained. Unemployment is on the rise, as is the overall output gap. Labor's position is thus deteriorating again. This suggests that occasional **weak spells in T-notes and bonds should be viewed as buying opportunities**, for instance when quarterly GDP numbers look better than expected. At the end of the year, the yield curve will probably be flatter than today. Corporate bonds will stay out of favor as the recession starts to hit the business sector – which, outside of finance and housing, has been in good health so far.

22. **The dollar looks oversold.** As mentioned earlier, real exports are rising rapidly and real imports are stagnating (they may already be falling on a month-over-month basis). Net exports are thus becoming, together with government spending, the main support for the economy. The depreciation is doing what it should be doing. Over time, the selling pressure caused by the trade deficit will therefore subside. The Fed's foot-dragging on rates will also help to stabilize the greenback.

23. **But the world is still flooded with dollar assets.** Moreover, the improvement of net exports is nice but not large enough to get the consumer-driven US economy going again. Further rate cuts are therefore likely, and so are further dollar depreciations.

24. In the 15-country **euro area first quarter GDP growth has probably been in the order of 0.5 to 0.7% q/q** (statistics on May 15). For the time being, the economic situation looks still fairly pleasant, as the ECB continues to emphasize. The latest employment statistics (for Q4) show a year-on-year increase of no less than 1.7%, the order inflow remains strong, industrial production was +3.1% y/y in February, and foreign balances are in equilibrium. At the same time, though, inflation was 3.6% y/y in March and thus way above the central bank's target of somewhat less than 2%. Going by the preliminary results from Germany and Spain, the inflation rate will drop to 3.1% in April and is thus finally moving in the right direction again. Overall so far, the strength of the euro exchange rate has neither had a visibly negative impact on growth, nor a positive impact on inflation. The ECB will therefore stay put and leave the main policy rate at 4%.

25. Investors are rather more skeptical about the euro area's economic outlook. During the past twelve months, the euro has appreciated by 14% and 16% against dollar and pound sterling, the currencies of the main trading partners. The US and the UK also happen to be in, or heading into, a recession. **Exports will soon be in trouble, seems to be the agreed conclusion.**

26. All the while, **European consumer demand remains depressed** – employment may be strong, but wage increases continue to be well below inflation. In January and February, real retail sales were, unsurprisingly, unchanged from one year ago. (The German Labor Office has just now released new unemployment numbers which show that the seasonally adjusted unemployment rate has increased from 7.8% in March to 7.9% in April – this is the first increase in a long time). Household demand was expected to be the main driver of growth this year. By now, this looks like another case of wishful thinking.

27. **The IMF is also painting a bleak picture.** GDP growth rates for 2008 and 2009 are forecast to be only 1.4% and 1.2% which is dangerously close to a new recession. The EU Commission predicts more robust rates of 1.7% and 1.5% respectively, but these are also significantly below 2.8% and 2.6%, the growth rates of the past two years.

28. The main euro area stock market indices have thus been down between 13% and 15% since the beginning of the year, or by about ten percentage points more than US indices. **On the basis of present and expected earnings euro stocks are significantly cheaper than their US counterparts**, as if the euro area, not the US was heading for a recession. This is not easy to rationalize. On the basis of estimated 2008 per share earnings, the DJ EuroStoxx 50 multiple is 10.6, whereas the S&P 500 costs 15.0!

29. The same with euro government bond yields**. Nominal rates are quite a bit higher than in the US, not only at the short end where policy rates dominate but also at the long end which is mostly driven by inflation expectations. This is in spite of lower actual and expected inflation, and much smaller government budget deficits. 10-year Treasuries yield 3.80%, 10-year Bunds 4.14% this morning.**

30. Tellingly, **investors also seem to distrust Italian and Spanish sovereign borrowers**, and to a lesser degree the French state as well. Why else would they demand, in the 10-year range, yield spreads over Bunds of 45, 28 and 22 basis points respectively, much more than usually? The assumption must be that the coming growth slow-down has significantly increased the risk that the currency union will be blown apart.

31. This is totally unwarranted, no matter how aggressive Messrs. Sarkozy and Berlusconi behave vis-à-vis the ECB, and no matter how dangerous the bursting of the Spanish housing bubble may be. **The advantages of being inside EMU far outweigh the disadvantages**: on the one hand historically low real long term interest rates, low inflation, cheap debt service and favorable terms of trade that come with a strong currency, on the other hand a loss of monetary autonomy and thus the inability to manage the business cycle. Just imagine what would happen to its debt service if Italy decided to leave EMU.

32. This suggests that **Italian government bonds are a plausible (and almost as liquid) alternative to Bunds, and especially to US Treasuries.**

33. **Markets also believe that the euro area has a banking crisis of its own, if a somewhat less serious one than America's.** At 46 basis points, the yield difference between 10-year swaps and 10-year Bunds is two and a half times wider than before August 2007. The 3-month LIBOR rate is 4.86%, compared to the ECB's 4% policy rate - a 20 bp gap between the two used to be the norm before the crisis.

34. It could be that investors wonder who will do the bailing out in case one of the major banks threatens to go under. The case of Societé Générale has shown that the authorities of the country where the institution is headquartered will assume the responsibility. This has settled the issue, I think. **The risk premia are too high.**

35. **The euro exchange rate has mostly appreciated by default**, because it is the most obvious alternative to the dollar, not because the continent has attracted a lot of direct investment or because it was running a large current account surplus. Had China a more liberal capital and money markets, and would Japan offer higher interest rates, the euro would have appreciated by much less.

36. As it is, there are **no indications that the demand for dollars might pick up** – too large is America's current account deficit, too high the risk of a recession, and too low the level of interest rates. Nor will China's and Japan's policies change. China needs high growth rates to accommodate at least 10 million new workers every year, and Japan is not yet sure that deflation has ended – in order to keep the yield curve positively sloped, money market rates have to be close to zero.

37. **For the foreseeable future the euro will therefore tend to strengthen.** To be sure, its PPP-level is in the order of $1.10. The turning point will come once the ECB considers to cut interest rates (no indication yet), or if there are clear signs that the US current account deficit is heading toward a sustainable monthly deficit of $20bn or less, or when the Fed starts raising rates again. No one will ring a bell, when the euro finally goes into reverse. By that time it could be near $1.80.

38. **The signals we get from commodity markets are in stark contrast to the arguments presented above.** We may be close to a major correction, but prices are still extremely high. When everybody argues that this time things are different, that commodity price levels are fully justifies and have actually plenty of upside potential, then it is bubble time. I have to admit that I tend to predict bubbles to burst much earlier than they eventually do, but I have decided not to be deterred by the majority view – the turning point is reached after the last bear has turned into a bull.

39. In general, **commodities are easy to produce, their supply is frequently inelastic in the near term but usually elastic in the medium term. Prices typically fall significantly during global "recessions", and rise significantly toward the end of long economic booms.** So far, it has been accepted wisdom that the relative price of commodities is on a downward trend. Let's have a closer look at some key commodities:

    - Gold is now at $869 an ounce: it had hit a high of $830 in early 1980; inflation threatened to get out of control at the time. When central banks took up the fight against inflation, gold went into a long decline – price recoveries were smaller than losses during recessions. A low was reached only eight and a half years ago at $254, followed by a steady rise to $1,000 in early 2008. **The gold price is now crashing and seems to be heading toward $500 or less.** The latest inflation scare is about to end!

    - **Nickel costs presently $29,000 a ton. Prices have always been quite volatile – and usually much lower!** During the 14 years before December 2003, they were between $4,000 and $10,000, and between $10,000 and $15,000 in the following two years. They then took off and reached $51,600 one year ago, from where they promptly dropped like a stone. Since mid-2007 they are relatively stable in the $26,000 to $33,000 range. The demand for high-grade steel remains an important support – think global infrastructure boom and a car for every Chinese.

    - **Copper prices** are mainly driven by housing and electricity but also by manufacturing in general. They are at $8,540 a ton today. To recall, for decades, until the end of 2006, they had been in the $1,500 to $3,000 range. After the following sharp increase they have moved sideways around the present level. Volatility is very high, and recessions have major effects.

    - **The oil market continues to surprise on the upside. Even at today's $115 a barrel oil looks very toppish.** For twenty long years, from early 1984 to the end of 2003, it had cost 15 to 30 dollars. As recently as December 2001, during the last global recession, it could still be purchased for only $20. The end of rising oil output continues to be predicted, but so far there is no indication that the daily output will stop to rise by one to one and a half million barrels a day, year after year. High prices make substitutes such as coal, gas, nuclear and renewables more attractive, stimulate exploration, and induce consumers to economize. The higher the price, the larger the supply, the smaller the demand, and the likelier that oil prices will drop. The process is probably under way by now.

40. **Food prices are also at exaggerated levels.** Granted, there have some structural changes, such as the new competition between men and cars for agricultural land (bio fuels!), or the steep increase in the grain-intensive production of meat as living standards in emerging economies take off, but it is only short while ago that all the talk was of absolutely falling food prices and overproduction.

41. **Because food is perishable, it can not be used as a store of value and will never be an inflation hedge** - as many seem to be thinking these days. Food is, quite to the contrary, an important driver of inflation these days. Prices are more or less determined by physical demand and supply in a given year. Speculators or “inflation hedgers” who have recently moved into food, can contribute to bubbles, but since they have to take profits fairly quickly due to the nature of the underlying assets, prices will sharply drop again. The key considerations going forward are that productivity gains in agriculture will remain stronger than population growth for decades, and that bio fuel is probably a dead-end strategy. **Food can only be a viable asset class if prices were rising along a long-term trend. This is not the case.**

42. Finally, a word about **Russian markets**: real GDP growth has been no less than 8.1% y/y in 2007. The IMF expects 6.8% for this year and 6.3% next year. Money supply still expands at rates between 40 and 50%, mostly caused by interventions in support of the dollar. At the same time, the nominal trade-weighted rouble exchange rate (where the euro has the largest weight by far) continues to depreciate. As a result, consumer price inflation has taken off and has reached 13.3% y/y in March.

43. **The authorities are not overly worried. They are mostly concerned about maintaining high output growth** and to catch up with the West. In 2008, nominal GDP per capita will be about €7,460 (at today’s exchange rate of 36.83 rouble per euro), compared to Germany’s €31,000. It is still a long way to go.

44. State control in several dozen so-called strategic sectors remains strong. This is one of the reasons why manufacturing output grows by less than real GDP. Another is the Dutch disease mentioned above. Since the **government taxes oil production so heavily, earnings of oil producers and therefore oil output are not rising as fast as they could**, while foreign direct investors are often scared away by stories about unpredictable state interventions.

45. **The main drivers of economic growth are the construction sector, private consumption and government spending.** The latter has been expanding at a breathtaking rate of 60.6% y/y in Q1 this year. Since state revenues are expanding just as fast, the budget surplus in Q1 has increased to 6.6% of nominal GDP. Even if commodity prices fall significantly from their present level - as the world economy slows – it can be expected that the government will be able to uphold overall demand for a while, given this surplus and its huge reserves. Borrowing in the capital market is a so far untapped source of future state funds.

46. **Trade volumes are the main drag on Russia’s growth at the same time as the nominal trade surplus keeps rising to record highs.** Nominal merchandise imports were 33.9% y/y in Q1. Since import prices are rising more or less as fast as average producer prices in the countries of origin times the annual trade-weighted depreciation of the rouble, this probably translates into a real import growth rate of about 25%.

47. **Russia and its commodities are a key reason for the economic slowdown in Western Europe and the rest of the OECD, but Russia's imports are also a growth engine, especially for the European Union and all producers of manufactured goods.**

48. Investors must be aware of the **high volatility of asset prices** in a still relatively small and not always transparent market. This is the flip side of rapid economic growth and the positive long-term outlook for a country that is richly endowed with resources, including a well-educated labor force.

49. Stock prices for the 50 liquid names in the RTSI$ index are relatively low, with a 2008 p/e ratio of 9.2. According to the relevant pages on Bloomberg, earnings growth in this segment of the market is not expected to accelerate. It may reflect apprehensions about future oil, gas, metals (steel!) and electricity prices. Better to **focus on under-analyzed second and third-tier names** in sectors which benefit from buoyant consumer demand, construction activity and government spending (infrastructure!). Valuations are usually much lower than those of better-known stocks.

50. **For the courageous, the rouble-denominated municipal and corporate bond market may be worth a look.** There are about two new issues a week, typically with 2-year durations and yields in the range of 6 ½% to 12%, depending on the rating or the reputation of the issuer. Yields are negative in real terms, but for foreign investors this does not matter much as long as they can be sure that the rouble will continue to appreciate against the dollar. For the time being, this looks likely. They also get their money back fairly quickly and can re-invest at more favorable rates should yield levels rise.