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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

by Dieter Wermuth*

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1. **Most of the imbalances that had characterized the global economy in recent years have disappeared by now or are in the process of disappearing.** The US current account deficit is shrinking, the dollar is no longer overvalued, various housing bubbles have burst, the credit crisis is on the mend, and risk margins seem to converge toward normality. This is why global stock markets are holding up well in the face of slowing output growth and rising inflation.

2. The majority of investors assume that the worst is over. They argue that money is made by moving into assets when they are cheap, before their prices take off again. We are getting closer to that point but there is certainly no need to rush.

3. This is not least because **one major bubble remains: commodities, especially oil prices**. They have the potential to disrupt growth and employment in all countries that are importers of raw materials, and they will disrupt economic activity in commodity producing countries as well once prices collapse, which they must one day. As in all major oil crises before, global growth will be reduced significantly.

4. **There are also feedback effects from the deflation of the other bubbles**. Think of the greatly improved competitiveness of US companies, the wealth effects from plunging house prices, or banks' tighter lending standards. They have only just begun to work their way through the systems. Tomorrow's structure of global demand and supply will be very different from yesterday's. As a minimum, it will take a year before world real GDP growth will be back to the 5% rates one had become used to. Even two years looks optimistic. Meanwhile, the risk of a global recession continues to loom large.

5. For investors the **main themes at this juncture** are the recession risks in advanced economies, the on-going boom in key emerging markets, the likelihood that commodity inflation will spill over into general inflation, and whether exchange rate adjustments have largely run their course. It is still not clear to me whether the most likely, and relatively benign, outcome is stagflation, or whether we are heading toward recession and deflation as a result of general deleveraging, ie the reduction of debt at the expense of capital expenditures and household consumption.

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6. For a long time, **the US current account deficit had been the most dangerous of all bubbles**. The richest and largest country became a net capital importer while the rest of the world, and especially its poorer parts, became net capital exporters, in a reversal of what seems plausible and desirable. Money was (and still is) flowing uphill rather than downhill, so to speak. Most of America's capital imports came in the form of purchases of US Treasuries by foreign monetary authorities. These reflected interventions in support of dollar pegs of countries such as China, Brazil, Russia, India or Taiwan; in this way their international price competitiveness was to be preserved. As a result, the dollar has depreciated only gently and has remained fundamentally overvalued.

7. One effect of that strategy has been the **huge increase of international reserves of developing and emerging economies**: over the past seven years their average annual growth rate has been no less than 27%. Since non-sterilized interventions blow up base money one for one, liquidity in the dollar-pegging countries has exploded which in turn had initially triggered stock market and housing bubbles; by now consumer price inflation in emerging economies has taken off as well and has become a new risk factor.

8. The large cushion of reserves had the **welcome side effect that these countries could pursue growth policies without external financial constraints and without interference from the IMF**. It has been one of the success stories of this era. However, since it is not possible to let inflation rip if the majority of the population is poor, we are coming to the end of that road right now. Rising inflation has already caused social unrest in many developing and emerging countries; their mostly autocratic regimes are getting nervous. Monetary policies (which are still mostly very expansionary) will thus be tightened, and FX market interventions will increase by less. This will keep the dollar under downward pressure.

9. **From a US perspective, the current account deficit has mostly been regarded as a good thing**. In 2005 and 2006 it exceeded 6% of GDP, but the funding had not been a problem which meant that there was not much of an incentive to reduce it. Thanks to the large net inflow of foreign capital, the investment ratio has exceeded the national savings rate by a wide margin (ie by the equivalent of the current account deficit). The capital stock was therefore growing at a faster rate than would have been possible if only domestic sources had been available. Capital inflows from abroad have been behind America's productivity miracle, and have also boosted household consumption. Nothing to complain about.

10. **The benign neglect of the US current account deficit during the past ten years is understandable because inflation had remained moderate, at least until recently**. Interest rates did not need to be raised to attract foreign capital. The dollar had depreciated more or less steadily since January 2002 – in trade-weighted terms by 35.5% between then and now, but this did not lead to an acceleration of inflation and was therefore no cause for worry.

11. Global unit labor costs continued to fall significantly. America**, in spite of the weak exchange rate, thus did not import inflation.** Indeed, as recently as early 2006, US import price inflation had been negative. Monetary policy could afford to be very easy, and asset prices and leverage took off as a result. According to the Greenspan doctrine it was not necessary to do anything against asset price inflation. Now that bubbles have burst, the Fed has aggressively moved into action. But expansionary policies are, for the first time in at least a decade, constrained by unacceptably high inflation (presently 3.9% y/y).

12. **Dollar weakness and below-potential real GDP growth have finally brought about an impressive reduction of America's current account deficit.** The main global imbalance is therefore on the way out – or is it? Over the past year to Q1, the export volume of goods and services has increased by 9.5% while real imports have been up by only 0.7%. Foreign trade has become the main contributor to output growth. In nominal terms, the improvement is less visible, as import prices are rising much faster than export prices - 15.4% vs. 7.7%, y/y in April -, but even so, the deficit is expected to fall to 4.3% of GDP in 2008 (IMF forecast).

13. On the assumption that the dollar depreciation has more or less ended by now, **economists at the IMF and elsewhere are predicting that the US current account deficit will stabilize in the neighborhood of 4% of GDP for the next half decade**. This is such a huge number that I wonder whether it can be called a new equilibrium. What is so great about US assets to attract annual net capital inflows in the order of $600bn, given the alternatives in Europe and in emerging markets? The world is already flooded with dollars. Many central banks are reconsidering their inflation-prone dollar peg.

14. Won't market participants demand a further reduction of US asset prices before they finance such a shortfall? My guess is that they are in no rush yet to move back aggressively into American markets. **They can wait for even lower prices**. House prices have been declining for a while, and commercial property prices have begun to plunge as well. An end is not in sight.

15. **Since a recession is under way now, it is also fairly certain that corporate profits will fall, as they always do in recessions – and so would stock prices.** To assume that profits of the S&P 500 companies will be about 50% higher this year than last – which is the consensus among analysts, see page WPE on Bloomberg – looks very much like wishful thinking. Consumers – whose spending accounts for no less than 72% of GDP – are presently in a state of shock: employment numbers tumble, their housing wealth declines, and energy prices take a big bite out of their pay checks. A serious recession is therefore unavoidable, it seems to me.

16. **Are dollar bonds therefore attractive for foreign buyers?** Normally, the prospect of a recession implies that inflation and bond yields will come down which makes bonds a good bet. But the Fed has already stopped cutting the Funds rate. This has been in response to increased (imported) inflation risks. So there are no favorable expectations about short-term interest rates any more which might stimulate the demand for bonds. A further negative is the fact that dollar government bond yields are very low in real terms. While US bonds are a safer bet than equities at this point they are not really cheap.

17. The conclusion about **the US balance on current account deficit is therefore that it will have to shrink further before it reaches equilibrium**. Capital inflows can not be taken for granted as long as the outlook for US asset prices is as bleak as it is today.

18. Whether further weakness of the dollar exchange rate is an essential element in the adjustment process is not clear. It would certainly help, but the depreciation has already been significant, so much so that one could lean back and watch market forces do their job. Long time lags are normal. At the same time, it would be premature to expect that the dollar will soon swing back to its purchasing power parity, ie to around $1.20 vis-à-vis the euro. The temporary undervaluation is a key element in restoring the health of America's foreign accounts. Investors are not yet ready to accumulate dollar assets on the scale they had in the past.

19. A more serious risk is that **market participants get impatient about the stubbornly large current account deficit** – the latest oil price explosion may well drive America's monthly trade deficit beyond $60bn again. They may also conclude that the Fed will be forced to cut rates further if housing and industrial production numbers turn out worse than expected. The strong build-up of inventories in the first quarter could have an echo effect in the present quarter, and real GDP growth could thus actually turn negative.

20. **The ECB, on the other hand, continues to sit tight and pretend it is more concerned about inflation than about growth** at this point. The hawks on the board of Europe's central bank like to float the idea that a rate increase is still a possibility as long as inflation remains so far above the reference level of below 2% - it is presently at 3.3% y/y.

21. If all this comes together we may still see a final sell-out of the dollar. In previous FX market cycles such an exaggeration has been the rule rather than the exception. **Exchange rates tend to over and undershoot.** This would create a new and dangerous imbalance, though, and cause new dislocations.

22. **The shrinking US current account deficit means shrinking surpluses in the rest of the world**. These surpluses have also been imbalances of sorts, but they have not been as critical as America's deficit. For one, even as an aggregate, the surplus was not so large in relative terms (because the GDP of the "rest of the world" is about three times higher than that of the US), and secondly, many of the currencies of the surplus countries are subject to capital controls and are less important for the global economy than the dollar, the key reserve currency.

23. But it is clear that **they can no longer rely on a further increase of real net exports to stimulate their growth.** The positive side of Americans' free-spending ways (which was responsible for the US current account deficit) had been export-led growth in most emerging economies, but also in Germany, Japan, or Switzerland. This effect has gone into reverse now. It has a deflationary impact. Smaller current account surpluses in emerging markets also mean that there is less need to intervene in foreign exchange markets. Expect that part of money supply growth that has been driven by interventions to slow.

24. **The obvious way to keep the economy growing is to stimulate domestic demand**. Russia's government, for instance, has already boosted its spending by 60% y/y in Q1. It does not make sense for emerging economies to keep exporting capital on a huge scale, given the need to improve the infrastructure and to grow the capital stock in the business sector. Stronger domestic demand in the world outside the US is exactly what the doctor would prescribe in order to achieve a more balanced global growth pattern: weaker domestic demand in the US, stronger domestic demand elsewhere, including the euro area and Japan. Current account imbalances would disappear in no time.

25. Will it happen? Inflation in emerging economies would not necessarily accelerate if they went for such a shift in demand: the inflationary effects of lower interest rates and more expansionary fiscal policies would be compensated by the deflationary appreciation of the exchange rate. Rather, the near-term problem is structural, as production facilities geared toward exports would have to be retooled for domestic clients. Imports would rise as well. There could be frictional unemployment as a result. Politicians are probably afraid that their currencies might appreciate so much that their successful export-driven growth model would have to be scrapped – and they don't believe yet in the alternative domestic demand model.

26. So it is likely that **global current account imbalances will be reduced only gradually in response to a new structure of demand.** But they have to be reduced further one way or other because they are not yet sustainable. This implies that exchange rates will remain the key adjustment parameters. **Since most emerging economies will stick to their dollar pegs or managed floats, the burden will fall on the shoulders of the euro. Its further appreciation is inevitable.**

27. To turn to the **other imbalances**, the American and Spanish housing bubbles have shrunk significantly already. **In the US, prices and output of homes are still declining**, and it may take another year before a rebound can occur. Many households have net negative equity which means their mortgage debt is larger than the value of their property. They are forced to cut consumption in order to repair their personal balance sheets at a time when the labor market situation deteriorates rapidly.

28. By some measures, **Spain's bubble** may have been bigger than America's but its impact has been manageable because the country accounts for only 12% of the euro area economy. House prices have just begun to fall. In any case, Spain, Europe's former growth engine, is turning into a laggard – with very sound financials, though. In general, **the euro area as a whole has not been afflicted by a housing bubble**, but residential housing – an important part of domestic demand – is not contributing much to GDP growth. In the UK, the housing boom is over, but the deflation of the bubble is only at an early stage and will therefore be a drag on growth for some time to come. This prospect is the main reason for the extraordinary weakness of the pound against the euro.

29. There are also **booming housing markets in liquidity-rich emerging markets** such as China and Russia, but it is difficult to say whether they have the characteristics of a bubble. The quality of the existing housing stock is so poor in these countries while income growth is rapid that double-digit growth rates of housing completions could easily persist for another ten years. From a global perspective this is actually how it should be.

30. **The credit crunch, meanwhile, continues but the major risks have probably been defused**. Lower interest rates in the US, an aggressive and indiscriminating supply of liquidity to anybody who cared to ask, rescue operations for important banks that had been teetering on the brink of insolvency, large-scale write-downs of toxic assets and hundreds of billions of fresh capital have all helped to stabilize the situation. New moral hazard problems have been created in the process.

31. Central bankers on both sides of the Atlantic and in Japan, as well as analysts who do not work for financial institutions, continue to emphasize that the crisis is by no means over. The industry as a whole will undergo significant structural changes, away from the "originate and distribute" to the traditional "originate and hold" model. The sector as a whole will be regulated more tightly, and will have to de-leverage. For a while at least, it will therefore cease to be a growth engine. This is particularly true for the Anglo Saxon countries and Switzerland.

32. **How long the oil price bubble will last is anybody's guess**. The longer oil prices stay where they are the likelier is a serious global recession. I have problems understanding what is happening. Suddenly the world is running out of oil, the supply curve is almost vertical, and professional oil people who just two years ago were predicting prices of less than $50 are now not hesitating to call for $200 in the near future.

33. **Commodity prices, without exception, move in cycles, occasionally called pig cycles**. If prices are high, three developments set in which will bring them down again: 1) people try to get around with buying less, for instance by driving less or reducing the temperature in the house; 2) they will look for substitutes, for instance coal, gas, nuclear power or renewable energy; and 3) supply will be stimulated by intensifying exploration, technical innovations such as horizontal or deep-water drilling, by starting to exploit oil fields in national parks and other nature preserves, or by going after tar sands and oil shale.

34. **Not all of this takes a long time. So why aren't oil prices coming down?** We know that the timing of turning points is difficult, and economists like myself tend to expect them too early. Think of the Japanese stock market and property bubbles, the dotcom bubble, or some exchange rates. In the end, the economic arguments always turn out to have been correct, but this is of little use when the bubble bursts two years later than forecast. In the present end game of the oil price rally, we see everybody busily revising their target prices - $200 is almost consensus now. Another driver is the so-called short covering. Market participants who had sold oil forward two years ago for, say, $90, an entirely sensible deal at the time, have to buy oil in the spot market for more than $130 to meet their obligations. This drives up the price even more. As they say, not very helpfully, when the last bear has given in, we will have reached the turning point.

35. In 2008, the world's oil bill, under the assumption that the present spot price of $132 will also be the annual average price for the year, is $4.2tr. To put this in perspective, the IMF has just forecast that the global GDP at current exchange rates will be $60.1tr. Considering that the prices of other sources of energy have also increased sharply, I would estimate that the total energy bill has increased from about 5% of GDP to about 10% within just two or three years. It is almost a no-brainer to **predict that we will get a global recession, ie growth of less than 3% and steeply rising unemployment if prices stay where they are.** We get a massive re-distribution of income from energy importing to energy exporting countries who are the winners in this game. They account for just 10% of the world's population. It is equally clear that the oil price will collapse once such a scenario begins to unfold.

36. As always, **some concluding remarks on Russia** (the country which is the main focus of the four hedge funds for which I act as adviser): Its economy is, of course, well positioned if the assumption made in the previous paragraph proves to be realistic. It benefits from the unprecedented improvement of export prices relative to import prices. While real GDP presently grows at a rate of about 8%, real national income expands by about 12 or 13%. Domestic demand is therefore well supported and very strong; the standard of living of the average citizen is rising even faster than in China.

37. **The risks are not small, though**. With monthly wages rising at a rate of almost 30%, government spending expanding at an even higher rate, imports booming, liquidity still increasing at annual rates in the 40 to 50% range, real short-term interest rates negative and near-full employment, inflation threatens to get out of control. The most recent statistics were 14.3% y/y for consumer prices, and 27.4% y/y for producer prices – and, not surprisingly, the trend is up. These are scary numbers. At the same time, the government continues to run a huge budget surplus, the surplus in the balance on current account has been rising again, and international reserves have increased by $147bn to $541bn over the past year; they are the world's third largest.

38. **A big decline of commodity prices will quickly lead to a turn-around in the balance of payments. It would put an end to the pleasant situation where incomes are rising faster than output.** Liquidity would also dry up as there would be no need to buy dollars and euros to hold the rouble exchange rate down – it would fall on its own which in turn will reduce imports and trigger an improvement in real net exports. Domestic demand would suffer, but inflation would probably come down.

39. Note, however, that the **government has a lot of ammunition left for rainy days**. It could start to tap money and capital markets more aggressively and it could – and will – lower taxes. Not to forget, both business and households have very low debt levels and are thus able to maintain spending by borrowing more. The financial sector is still underdeveloped. Banks will thrive in a lower-inflation environment.

40. For investors in Russian assets, the **near-term outlook is rather good**. Especially stocks which benefit from the domestic demand boom should do well. Their prices are no longer low, though. Commodity names, on the other hand, are relatively cheap because of the risk that oil, gas and metal prices are unsustainably high and will come down. The longer the commodity boom lasts, the more attractive they get.

41. **Medium-term, the risk is a major correction of the markets for raw materials**. Tight stop-loss limits are therefore a must. Longer-term, Russia will probably achieve a more balanced pattern of growth, ie reduce its dependence on commodity exports and imports of manufactured goods. It still has a long way to catch up with Western European standards, but in view of its unparalleled endowment with natural resources and its large domestic market, it is well positioned to achieve this. Many years of high growth are not unrealistic, provided the government navigates skillfully through the cross currents which lie ahead.