WEBLOG

Wermuth's
Investment Outlook

June 2008

ZEIT online • HERDENTRIEB

blog.zeit.de/herdentrieb/

Wermuth's Investment Outlook

by Dieter Wermuth*

June 28, 2008

1. **Here are my main propositions.**

- Central banks begin to worry more about inflation than deflation; rates of capacity utilization are high, emerging markets have become exporters of inflation.
- Interest rates are rising; this will somewhat exacerbate the slow-down of the global economy.
- More importantly, record-high commodity prices cause a severe loss of purchasing power and a weakening of consumer demand in importing countries, including heavyweights such as the US, the euro area, Japan, China and India.
- The US suffers additionally from an almost unprecedented housing slump and will grow below par for at least another year.
- A further depreciation of the dollar is likely.
- Emerging economies will be hit by this, but they are less and less dependent on the US: their monetary policies remain expansionary, spending on infrastructure is strong, as are exports to Europe and oil producing countries.
- Corporate earnings in the OECD area are under pressure; exporters to commodity producing countries are ok but firms that depend on domestic demand are not; stocks will decline further.
- For cyclical reasons, prices of raw materials are about to stabilize and then to fall.
- Russia is a main contrarian story, but exposed to accelerating inflation and dependent on commodity prices.

2. **What happened to deflation?** For central banks, the main worry these days is inflation, not deflation any more. The major exception is probably the Fed which hesitates to tighten policies for fear of pushing the US economy over the brink. All around the world, inflation has accelerated sharply. According to its latest Global Data Watch, JPMorgan expects that in 30 out of the 31 countries it analyses, interest rates will either remain on hold or be increased. Only New Zealand will cut rates - from 8 ¼% to 8%. Consumer price inflation in developed markets is 3.3% y/y, and 7.8% in emerging markets - both rates are about twice as high as one year ago.

3. Deflation is still a serious risk, but not in the near term. **All new price statistics disappoint on the high side** so far. Most worrying is the fact that on the earlier stages of the production chain both costs and prices are rising considerably faster than on the consumer level. There is thus a lot of inflationary pressure in the pipeline. Passing this on to consumers is getting more difficult because they are suffering from an energy-related loss of purchasing power – profit margins will therefore decline.

* Dieter Wermuth works as a consultant for Wermuth Asset Management GmbH and regularly contributes texts to the HERDENTRIEB weblog which is available on the ZEIT online website.

4. **I have long thought that deflation would be caused by the bursting of housing bubbles in the US, the UK, Spain, possibly even China, as well as sharp declines of some overvalued stock markets.** Since housing bubbles, in particular, were accompanied, as always, by excessive borrowing, the decline of real estate prices would push large segments of the population financially under water as their debt suddenly exceeded the value of their assets. Net negative equity leads to a sharp reduction of consumption, or an increase of savings. Everybody tries to repair their personal balance sheets.

5. Another dangerous development with the **potential to generate a deflationary fallout had been the steep increase in risk tolerance.** Until last summer, risk premia of below-investment grade bonds had shrunk to fractions of what they were in normal times. Very low real bond yields had made investors desperately searching for attractive alternatives. Risk aversion went overboard – since inflation was so low it was assumed that monetary policies would remain accommodative.

6. As premia have risen again in the wake of last summer's global financial crisis, investors - and creditors in general - were forced to do large write-offs. Asset backed securities and many US mortgages also turned out to be overpriced on a massive scale. Banks had to shrink their assets, ie their lending, in response to the decline of their equity base. On both sides of the Atlantic, banks had to be recapitalized to make up for the losses, others had to be rescued from default to avoid a collapse of the financial system. This has been the Japanese story of the nineties, or that of the US depression of the thirties, both of which **had ended in deflation.**

7. The steep increase in oil and other energy prices poses another risk, initially not of deflation but of global recession. Over the past six years, spending on crude oil has increased from $0.7tr to $4.2tr annually – assuming an average oil price of $135 per barrel in 2008. **Total spending on energy this year will probably reach something like 12% of global GDP which is at least three times more than in 2002.** The losers in this process far outnumber the winners (the oil exporters), and the world savings rate goes up. Everywhere, consumers are increasingly shocked by their loss of purchasing power and are forced to tighten their belts. All major oil crises since the early seventies have led to recessions. This one will not be an exception. A genuine oil crisis certainly increases the probability of deflation, especially as it comes in combination with various bursting asset price bubbles.

8. Yet, the dominating topic of the day is accelerating inflation. **The goldilocks era of high growth and low inflation has come to an end.** Expansionary monetary policies had long been possible because of emerging markets' reserve army of underemployed workers, rapid productivity growth on the back of a capital spending boom, and undervalued currencies. Inflation seemed to have ceased to be a problem. Wage inflation, in particular, remained moderate. Intensified international trade made workers in the rich countries compete directly with their poorer colleagues in Asia, Eastern Europe and Latin America.

9. By now, the reserve army has shrunk considerably while the global rate of capacity utilization has reached a long-time high. In China, wages are presently increasing at rates of 15 to 20% - which forces more and more Chinese entrepreneurs to move production elsewhere. At the same time, currencies are to some degree allowed to float up against the dollar. Pegging them to the greenback is not of crucial importance any longer: the dependence on the US has declined, thanks to strong and frequently self-sustaining domestic demand and the diversification of exports to other regions of the world. **Emerging economies have become exporters of inflation.**

10. They have also become formidable competitors for the world's reserves of oil, gas, metals and food. Since they are financially mostly very sound, they can afford to subsidize the consumption of energy and agricultural products. Because their economic growth remains robust, they have thus become the main force behind the explosion of commodity prices. There is not much OECD countries can do in the near term. Structural changes that will reduce the dependency on imported energy - such as higher taxes on energy consumption - take a long time and are often politically not feasible.

11. **One legacy of the goldilocks era has been the huge wave of liquidity** that was created by the combination of the US balance on current account deficit and the interventions of monetary authorities in emerging economies which were aimed at preventing revaluations of their currencies. By buying dollars on an almost unlimited scale (in this way subsidizing the US consumption boom), they expanded domestic money supply and credit at a rapid pace, long without having to pay the price in the form of rising inflation.

12. Between 2002 and 2008, the average annual growth rate of global liquidity has been in the order of 20%. By pegging their currencies to the dollar they actually adopted US monetary policies. Their fast rates of real GDP growth would have called for considerably higher real interest rates. The US was fighting deflation after the bursting of the new economy bubble in 2000 – as it turned out, the emerging economies participated in this fight.

13. Now the chickens are finally coming home to roost. **Globally, we have a combination of rising inflation and slower output growth. This is called stagflation** and, as we know from the seventies and early eighties, a very tricky situation for policy makers, especially, at this point, in the advanced economies: slower growth would suggest stimulative monetary policies while headline inflation rates well beyond comfort zones would call for a tightening of the reins.

14. **In the US, the dilemma is very pronounced.** The Fed funds rate is still only 2% and thus far below consumer price inflation which is running at a rate of 4.2% y/y. In real terms it is negative – as if deflation remained a serious threat. The Fed does not dare to raise rates significantly because employment continues to decline, real GDP is almost stagnating, and key leading indicators suggest that worse is yet to come.

15. **House prices are about 15% below their year ago level**. No one can remember anything like this. The price decline matters a lot because houses are by far the most important asset of consumers, and were for a long time used as collateral for retail borrowing. The so-called equity withdrawal, ie borrowing in the mortgage market and using the money for consumption, on the assumption that house prices would rise forever, is no longer possible. Add to that the shock from the energy price explosion, and it is hard to see how the all-important private consumption component of overall demand can recover.

16. The US is now in a situation where **real incomes are rising at a slower pace than real output.** After many years where the country could live above its means it must now live below. The best indicator for this is the terms of trade effect, the discrepancy between import prices (17.8% y/y) and export prices (8.0% y/y). Since real GDP is expanding at a rate of just 1% (saar) it is clear that real incomes are at best stagnating. A turn-around is not yet in sight.

17. **US corporate profits have declined three quarters in a row by now (y/y) and are 11% below the recent peak in Q3/06.** Banks, of course, are severely hit, but at the same time oil and commodity companies are doing fine. The overall picture is already rather bleak, while the full impact of the consumer slump has yet to materialize. Next victims could be large auto manufacturers and airlines.

18. **Consensus forecasts of brokers are certainly far too optimistic.** On the basis of price to earnings ratios, per share earnings this year will rise 51% (S&P500) and 15% (DJ Industrials) compared to the last four quarters (Bloomberg, page WPE). I find it hard to be so optimistic. It is typical for US recessions that profits (on a national accounts basis) decline by something like 15 to 25%. During the relatively mild recession earlier this decade the decline between peak and trough had been 22.4%. The odds are that America is only at the beginning of a rather long recession, and that profits will have to fall further. The stock market blues continues, especially in the banking and consumer-related segments.

19. The only factor that keeps the US economy moving is net exports, the difference between real exports and imports. They benefit from the large devaluation of the dollar as well as from the comparatively strong expansion of real GDP in the rest of the world. The quickly falling rate of capacity utilization also helps. But even so, **the current account deficit, at $706bn annualized in Q1, or 4.97% of GDP, remains stubbornly high. Since foreigners hold so many dollars already, the additional supply that is generated via the balance on current account weighs heavily on the dollar exchange rate.**

20. Some US assets are relatively cheap, such as real estate and stocks of companies that have been particularly hard hit. These will attract capital inflows. But money market rates are very low (3-month LIBOR is 2.8%), and so are bond yields (10-year Treasuries are 4.05%). Not only that, the probability is fairly high that cost push inflation will continue for a while, implying that the prices of all interest rate products could fall some more. There is also, to some degree, a backlash against selling supposedly strategic real assets to foreign investors such as Sovereign Wealth Funds – the US is content to sell paper IOUs (mostly Treasuries) or condos in Florida, but when the targets are Exxon, ports, or, some day, Cisco or Microsoft, the shutters tend to come down. **A weakening dollar thus remains necessary in order to attract foreign funds into less-than-real assets, ie assets that can be devalued via inflation and currency depreciation - and are therefore risky.**

21. **The euro area is also visibly slowing.** After very strong growth in the first three months, output in Q2 has probably stagnated on a quarter-over-quarter basis. Unemployment has been rising steeply in Spain, but even in Germany the improvement of the labor market has ended. All recent leading indicators – PMI, Ifo, incoming orders to the manufacturing and construction industries – are pointing down.

22. It is less the negative impact of the bursting of some regional housing bubbles (Spain, France, Ireland) or of the financial crisis but rather the massive increase of energy prices and the appreciation of the euro that have been behind the slowdown. Consumer spending was expected to be a strong driver of final demand this year, in lieu of net exports. As it is, **retail sales are collapsing, not expanding**: on a year-on-year basis, prices are rising almost as fast as incomes (3.7% vs. 4.2%); on a month-over-month basis, the trend has actually been reversed since the beginning of the year. Consumers have become cautious once again.

23. **The ECB is determined to raise interest rates by 25 basis points to 4 ¼% next Thursday** because it worries about a further increase in inflation expectations. The firm anchoring of these at below 2% is the central bank's overriding concern. So far, the hard statistics, all of them backward-looking, are still fairly strong. Yesterday's increase of Germany's consumer price inflation rate by 0.3 percentage points to 3.4% y/y has inevitably hardened its resolve to go ahead with tightening policies.

24. In an ideal world, the ECB would presently try to stimulate domestic demand (cut rates), the Fed would try to restrain America's domestic demand to make room for more exports (raise rates), while emerging countries would stop intervening and thus let their currencies appreciate. In this way, the euro area could grow faster, the US could reduce its current account deficit, and the others could slow inflation and become less dependent on exports. It is not going to happen because the players are not yet ready to cooperate. For **the euro area this means that it is facing an extended period of widening output gaps. I agree with the consensus opinion that real annualized GDP growth in the euro area will not exceed 1% until at least the first quarter of 2009.** Unemployment will start to rise again and import demand will slow – that for energy will continue to decline steeply.

25. **This is mostly bad news for the rest of the world** (the good news is that it helps to reduce oil prices). From a global perspective, the euro area matters just as much as the US these days, given the size of its GDP (€9.16tr vs. America's €9.01tr in Q1, at today's exchange rate) and the value of its imports of goods and services (excluding intra-regional imports, these are about 50% higher). For Asian exporters, the euro area has come close to par with the US, and it is a far more important destination for East European, South American and African exporters.

26. The ECB may consider to raise rates further in coming months. Near term, headline inflation will soon exceed 4% which could push up inflation expectations by another notch. But it would take a deep recession by now to bring down the domestic component of overall inflation far enough to compensate for imported inflation – over which it has no influence, except via further strengthening the euro exchange rate. There are obviously political constraints which will hold the ECB back on such a strategy. The young euro project could be endangered if the central bank proceeded fighting inflation no matter what this did to the real economy. **So the most likely outcome is indeed a wait-and-see policy after Thursday's move.**

27. **As in the US case, downward pressure on corporate profits and stock indices will persist.** Headwinds include a super-strong exchange rate, firmer input prices (in spite of the strong euro), tighter credit availability, increased interest expense and higher wages. Corporates are still quite sound financially, even strong, but a further improvement is unlikely. On the other hand, risk premia (based on trailing profits) are generous after the clobbering of stock markets this year. On the basis of this yardstick, European stocks are cheap compared to US stocks.

28. **Whether euro bond yields will rise further is not clear.** Investors may look beyond the present inflation scare and argue that because of record high oil prices the likelihood of a significant moderation of demand has increased a lot, including a global moderation. Wage inflation in the euro area has accelerated somewhat, but labor remains so weak that the risk of a new wage/price spiral is close to zero. I would guess that euro bond yields are close to their peak.

29. **One puzzle remains: how is it that 10-year Bunds yield 56 basis points more than 10-year US Treasuries?** Considerably more restrictive monetary policies in Europe (a flatter yield curve) have resulted in much lower medium term inflation expectations – shouldn't these be reflected in a lower, rather than a higher European yield level? Are markets telling us that in spite of the Fed's efforts, and in spite of expansionary US fiscal policies, the medium term outlook for the US economy is worse than for the euro area? The relatively small US difference between nominal bond yields and medium term inflation expectations points in the same direction.

30. **Japan has also hit a wall in recent months.** After a strong first quarter (real GDP up 4.0% saar), activity has probably declined in the second. Consumer sentiment indices are in a free fall, and income expectations have deteriorated dramatically. Household spending had been minus 3.2% y/y in May! Just as the rest of the world, the country suffers from rising inflation – if the June results for Tokyo are representative of what can be expected for the country as a whole, CPI will reach 2% y/y. Inflation is finally back, even though it is not generated domestically.

31. On the production side, **Japan benefits from its superior energy efficiency**: according to World Bank data for 2005, energy consumption per unit of real GDP was 95% less than Russia's, 88% less than China's, 50% less than America's, and 40% less than Germany's. It is thus well shielded against the oil price explosion. The country **also benefits from its relatively weak exchange rate in combination with falling unit labor costs, as well as a product mix that is well suited for the needs of its booming Asian neighbors.** Equities have declined less than in other countries this year as companies continue to restructure aggressively – most of them target double-digit returns on equity, the dividend yield is 1.74% and thus exceeds JGB yields (of 1.6% for the 10-years), and the price to book ratio of the TOPIX is a modest 1.46. Investors should focus on nuclear energy, solar cells, carbon fiber, construction machinery, or in general on companies that beneficiaries of Asian infrastructure investments.

32. While the **Bank of Japan is unlikely to raise rates (still at 0.5%)** - because of the weak economy -, bonds are still likely to suffer for a while and should be hedged. Inflation is now higher than the yield on 10-year government bonds.

33. **China remains the main culprit of the oil price explosion.** While I paid €1.56 per liter of gasoline here in Germany this week, the Chinese have to spend only €0.57 which is even less than what the Americans are paying (€0.67). The BP Statistical Review shows, that in the five years to 2007 Chinese oil consumption has increased by an average annual rate of 8.2% (India +3.0%, US +0.9%, Germany -2.5%). Energy is wasted on a massive scale (destroying the environment in the process) but so far it has not led to financial problems and may thus continue for some time. China's current account surplus is actually the world's largest ($372bn in 2007) which means it is also the world's largest net exporter of capital. Foreign reserves are approaching $1.5tr. No one can hold China back except its own population. But people have just begun to fall in love with cars and the lifestyle of the West and will resist any political attempts to curb oil consumption.

34. **Real GDP is still expanding at rates above 10% while industrial production is up 16% y/y.** Even though the investment ratio is extremely high, and potential real GDP growing very fast, inflation is becoming a serious problem. There are now occasional reports about social unrest as rapidly rising food prices hurt the poor.

35. Wages are up by about 20% from last year. There seems to be a shortage of skilled labor now. **China is thus losing its labor cost advantage** even though it remains large in absolute terms. The gradual appreciation of the yuan against the dollar is another factor that reduces the country's international competitiveness.

36. **For the time being, China is able to stick to its extraordinarily successful economic model: keep the exchange rate undervalued, avoid a liberalization of private capital exports, and pursue a policy of easy money.** One unwelcome result of these policies had been the stock market bubble of recent years. In the meantime, it has turned into a genuine crash which will probably lead to lower growth rates of private capital spending and consumption. There is another bubble that waits to burst some day – in housing. So far, there is no evidence of this happening. China will thus continue its rapid expansion of GDP.

37. **On the demand side, this is one of the main reasons why oil prices seem so well supported.** In the five years between 2002 and 2007, global oil consumption rose by 7.4 million barrels per day (to 85.2 mbpd). Emerging markets, including China and the former Soviet Union, accounted for 83.1% of this increase, and North America for another 18.4% - the rest of the advanced economies slightly reduced its consumption during that time. For now, the liquidity and export driven catching-up process of the poorer parts of the world continues, if at a less blistering pace than usual. It remains very energy-intensive. Just imagine for a moment that China will one day consume as much oil per capita as the US: This alone would require an additional production of 88.7 mbpd, ie more than a doubling of today's global oil output.

38. It is clear that something has to give. **The key adjustment parameter, of course, is the price of oil.** Since supply is so inelastic, both in the near and the medium term, **prices have exploded already. Big reductions in demand can be expected across the whole OECD area**, this time including the US, Canada and Mexico. Even in the emerging world, high oil prices in combination with a likely reduction of real GDP growth from 7.5% last year to 6.2% in 2008 will finally dampen oil demand significantly. High oil prices themselves increasingly put in question those up-beat GDP forecasts. Rather than growing their consumption again by 3.8% a year, as they have done in the 2002 to 2007 period, they may have to settle for 1 or 2% this year. Global oil demand may well stagnate from now on – unless prices come down steeply.

39. **How about the supply side of oil?** As prices have risen, more and more marginal production has become worthwhile. The question is whether anybody would bet on persistently high oil prices. Probably not, but even if prices fell back by 50%, ie to last year's levels, they would be considerably higher than only a few years ago. No one actually dares to predict such a decline. 200 dollars is the new target. If markets work (which we all firmly believe, don't we?) the incentive to develop marginal oil fields and oil substitutes must be very strong at present price levels. **It would be very unusual if supply did not react in the normal way – which means expand faster than in the past.**

40. In other words, **stable or declining demand in combination with more supply will put a lid on oil prices, and eventually bring them down steeply.**

41. **The main argument against such an outcome is politics** – if, to mention the biggest risk, Israel decides one day to destroy Iran's nuclear facilities and thus triggers a major war in the Near East, the oil supply curve would move instantly to the left and push prices into those stratospheric regions forecast by some brokers. This is granted. **The oil price may stay very high because it contains a high risk premium. Going by economics alone, it is more likely that it will soon collapse.**

42. Finally, some words about the **outlook for Russia**. The country's stock market suffers from the weakness of stock markets all around the world, especially America's, but on the other hand it is also a beneficiary of the energy price explosion. It is one of the few countries where disposable incomes are rising much faster than real GDP – because export prices have been increasing much faster than import prices. Domestic demand is therefore strong, especially everything related to infrastructure (or government) spending, construction, and household consumption.

43. **The rouble would appreciate significantly if the central bank would not massively intervene in foreign exchange markets.** Interventions are basically a doomed exercise, but for a transitory period politicians can indeed successfully reduce imports and boost non-commodity exports this way, ie protect Russian industry. Since the surplus in the balance on current account has been in the order of 8½% of GDP so far this year, there is an ongoing strong net demand for the currency. By buying more or less all dollars and euros that are offered for roubles, foreign currency keep rising and have now passed $550bn which is, of course, way above anything required to cover the country's import needs in an emergency.

44. The flip side of the interventions is the rapid growth of domestic liquidity which has become the driver of both demand and inflation. **Real GDP rose by 8.5%** in the year to the first quarter while consumer price inflation has accelerated to 15.1% in May.

45. The booming economy continues to boost the demand for labor, with the predictable effect that wages are rising very fast (31.8% y/y in May). A **wage/price spiral is in full motion**, and it is hard to see how it can be stopped, unless, that is, commodity prices suddenly decline, or the central bank decides to let the rouble float – in which case it may appreciate against the basket of dollar and euro by, say, 20%.

46. **Russia's monetary policies are much too expansionary for the good of the country.** Real interest rates are negative which means that savers have no incentive to bring their money to the bank, or to invest in rouble bonds. This is why the banking sector has to find other ways of funding (for instance in the euro markets), and why the bond market has corrected so much recently.

47. **Inflation rewards borrowers and punishes lenders, depositors, and savers in general. It also hurts those who are living on state pensions or other forms of fixed income.** If everybody was able to adjust to inflation, it would not hurt, and growth would not be negatively affected. But if inflation fluctuates wildly or accelerates all the time, it leads to a potentially explosive - because unfair - income distribution.

48. All this argues for stopping FX interventions and for a freely floating rouble. Since there is near-full employment, the negative impact on the Russia's real economy would be limited.

49. The administration is not yet there. It is enjoying the good times and does not want to throw a spanner into the nicely working growth machine. There is a large budget surplus these days, as revenues are rising even faster than expenditures (which are booming). All sorts of worthy projects can be pursued at the same time.

50. **The stock market, meanwhile, is not seriously overpriced, even though the inflationary environment suggests that there could easily be a bubble. The political risk premia seem to be high at this point, and investors are probably also wary of the danger of a steep decline of commodity prices in response to slower global growth.**

Disclaimer: We cannot give any guarantee that the information and data in this "Investment Outlook" is correct, and we cannot accept any liability whatsoever in respect of any errors or omissions. This document is a piece of economic research and is not intended to constitute investment advice, nor to solicit dealing in securities or investments.

Disclaimer: Alle Inhalte aus diesem "Investment Outlook" dienen nur zur unverbindlichen Information und stellen keine Anlageberatung oder Aufforderung zum Kauf oder Verkauf von Wertpapieren oder anderen Finanzmarktinstrumenten dar. Für die inhaltliche Richtigkeit der Informationen können wir keinerlei Gewähr übernehmen.