



Wermuth's Investment Outlook

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1. It is now consensus that the **global economy will continue to grow at a low rate for quite some time. There are no indicators to suggest that we are near a turning point.** Indeed, all incoming news and statistics point to a further deterioration. In the middle quarters of this year, the growth rate of the world's real GDP has probably decelerated to an annualized rate of less than 1½% - even emerging markets, financially sound as they mostly are, have begun to show signs of strain.
2. **Investors are not yet convinced that prices of equities, real estate and commodities have reached bottom. They prefer to stay on the sidelines, or buy Treasuries, Bunds, JGBs and Gilts, no matter that their yields are either below or close to actual inflation rates.**
3. **Not all is bleak:** 1. the improvement of the US balance of trade in the wake of the dollar depreciation proceeds quickly which will remove one of the key global imbalances, 2. the decline of energy prices begins to put money back into the pockets of consumers in importing countries, 3. food and other commodity prices are on the retreat as well, 4. the inflation outlook in general has improved considerably, 5. monetary policies in key economies are thus not only on hold, it is likely that they will soon be relaxed, and 6. corporate balance sheets are still healthy, with financials, airlines and (US) auto makers the main exceptions.
4. One of the surprises recently has been the **strong growth of the US economy in the second quarter.** While domestic demand has more or less stagnated, in spite of the tax rebates, foreign trade has almost fully accounted for the 3.3% annualized rate of growth of real GDP. The shift from internal to external demand is highly welcome and overdue. But, as always, sometimes there can be too much of a good thing. Not only that the improvement of America's trade situation means a corresponding deterioration in the rest of the world, ie a reduction of exports and an increase in imports - and thus slower growth -, the **deceleration of America's household and business demand may still get out of control.**
5. **US households suffer from at least four shocks:**
 - Since last December's high, **payroll employment has shrunk** at an annualized rate of 0.6%; it is increasingly difficult to find a job.

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- **Personal incomes are falling** in real terms; in July, they even declined in nominal terms (-0.7% m/m - or -1.5% m/m in real terms); the most recent headline CPI has been 5.6% y/y.
 - **House prices are collapsing**; they were almost -16% y/y in June; a large inventory of unsold homes suggests that prices may go down another 10%; more and more households are moving into net negative equity territory where they are forced to reduce their standard of living in order to restore their financial health again.
 - **Equity portfolios, including future pension claims, also lose in value**; people not only feel poorer, their borrowing collateral keeps shrinking as well. In 2006, the value of households' equity had been \$10.6 tr, that of non-financial assets, mostly real estate, no less than \$27.1 tr, for a total of \$37.7 tr. Assuming average prices of both asset classes decline 20% reduces their wealth by \$7.54 tr, the equivalent of 53% of 2008's nominal GDP (the data are from the OECD and the US Council of Economic Advisers). Even though these numbers are mostly just paper losses, the **negative wealth effect** on consumption will certainly not be negligible.
6. **In recent weeks the dollar appreciation and the decline of commodity prices have somewhat alleviated the situation of US consumers. But the terms-of-trade shock has still been massive until very recently.** In Q2, the prices of what Americans produce (the GDP deflator) rose at an annualized rate of 1.2% while the prices of gross domestic purchases, ie the prices of what they buy, were up 4.4% and thus by much more. At the margin, their output bought them less than what they produced.
7. It has been the other way around until recently – Americans used to be the world's consumers of last resort. **The terms-of-trade situation is now improving**, though. In recent weeks, the decline of commodity prices and the strong dollar have led to a fall in import prices that has been larger than the reduction of export prices (in August: -3.7% m/m vs. -1.7% m/m). As headline inflation comes down from now on, households' purchasing power is improving – but it remains well below last year's levels.
8. As far as its international competitiveness is concerned, **US business clearly benefits from the previous dollar depreciations** and, to a lesser extent, the fall in domestic capacity utilization rates. But in terms of earnings, the good times are over. Corporate profits had declined the fourth time in a row in Q2 and were 7.0% below their year-ago level. They are still almost exactly 100% above their cyclical low in Q3 of 2001. While banks, insurers, car producers and airlines have to go cap in hand to the government, to sovereign wealth funds and to private equity funds, asking to be rescued, **exporters and multinationals are mostly still doing fine financially.** This does not mean, though, that they continue to expand their business. The outlook for sales is so bad that they have become cautious. Nor are share prices doing anything to build confidence. Real spending on equipment has declined at an annualized rate of 1.3% during the first half of the year.
9. It is therefore an almost foregone conclusion that **US growth will be less than 1% annualized in the second half of this year and well into 2009.** This is almost a recession and the main reason why markets do not expect the Fed to raise the Funds rate - even though it is only at 2% and thus way below the 5.6% inflation rate. (Long-term inflation expectations are 2.2%) The steepness of the dollar yield curve – 2-year Treasuries at 1.87%, 10 years at 3.52% – is another sign that monetary conditions are very easy.

10. Fiscal policies will become more stimulative as well, but mostly because automatic stabilizers are kicking in, not for discretionary reasons. After the **nationalization of Fannie Mae and Freddie Mac** the government's gross debt has increased by almost 40% of GDP. The AAA credit rating is at stake, especially if more rescue operations become necessary. For the time being an all-out expansionary program is not in the cards.
11. **The other big surprise has been the sudden implosion of the euro area economy.** Well into the spring months it had seemed that the strong euro, the bursting of housing bubbles in the Club Med countries and Ireland and the energy-related purchasing power shock that hit consumers would be shrugged off. **In the first quarter, real GDP had still expanded at an annualized rate of 2.9%.**
12. **This has been the cyclical high, though, and it has been downhill ever since.** Sentiment indicators, incoming orders to manufacturing, retail sales have all been falling steeply, and industrial production and GDP have followed quickly. In Q2 real GDP has declined at an annualized rate of 0.8% and was thus only 1.5% higher than one year ago. The European Commission has just reduced its real GDP forecast for 2008 from 1.7% y/y to 1.3% y/y.
13. **It is not well understood why European employment has held up so well** – the latest statistic (Q1) shows that the number of jobs still exceeds last year's level by 1.6%. I have three explanations: 1. business considers the present slump to be of short duration and has decided to hoard labor, not least because firing and re-hiring is costly; 2. employment is a lagging cyclical indicator; the time lag may be even longer than in the US because labor markets are more rigid; but in the end, employment will almost inevitably decline in response to poor output growth; 3. it could also be that recent reforms have reduced the relative cost of labor which is now bringing about a new, more labor-intensive production function – this could also explain why productivity growth has become so anemic (let's hope this is mainly a transitory phenomenon on the way to full employment).
14. **Some stabilizers** are at work which will limit the decline of euro area output and may lead to an early recovery. One is the large depreciation of the euro against the dollar and all currencies pegged to it – in terms of prices, euro area firms have rapidly become more competitive again. Automatic fiscal stabilizers will also help – since the tax system as a whole is more progressive and the relative size of the public sector larger than in the US, the effects can be expected to be more significant. Further, the euro area had not been suffering from major imbalances, at least not in the aggregate: the balance on current account has been in slight surplus while the budget balance will show a deficit of just 0.9% of GDP this year. There is room for manoeuvre and pressure on policy makers to stimulate the economy has therefore been mounting. So far, however, finance ministers have prevented large-scale emergency programs.
15. **Another positive is the big decline of food, energy and other commodity prices** that began in early July. What is the opposite of a purchasing power shock? I don't know, but this is what will be happening. Consumer price inflation which had been driven up by these components now benefits from their fall. It has probably peaked in July at 4.1% y/y, reached 3.8% in August and is likely to hit 3% by year-end. Real wage growth would then be positive again and thus stabilize demand.

16. In spite of these positive factors, the **downside momentum of euro area GDP is so strong that another quarter-on-quarter decline in Q3 is near-certain (perhaps -0.6% annualized)**. Housing demand in particular is in a free fall in such large countries as Spain, France and Italy. The introduction of the euro in January 1999 had led to a large decline in real mortgage rates there which in turn had triggered long-lasting housing booms - or bubbles, to be more precise. These have burst. In France, sales of new apartments and single family homes have been -33.9% y/y in Q2. Spain has even bigger problems. Across the euro area, real estate prices are under downward pressure, but a stagnation or a slight decline is more probable than a crash.
17. Together with the 29% fall in stock prices so far in 2008 this still results in a sizable **negative wealth effect** which will hold down private consumption. On the other hand, the household savings rate is still 14% (gross, of disposable income). There will be some belt-tightening, but since there has not been any previous exuberance in the euro area as a whole, **household consumption will not fall through the floor**.
18. All this argues for a **wait-and-see monetary policy in the euro area**. At 4¼%, the policy rate is near its neutral level, above the actual inflation rate and well above medium-term inflation expectations. In a situation where the economy suffers from rising slack, rate cuts are more likely than further hikes. I guess that the ECB will act once the trend of falling commodity prices and falling consumer inflation rates is more firmly established. We are not yet there. The new projections of the ECB staff show, compared to last time, higher inflation rates and slower economic growth, and for now serve as a justification to stay put.
19. According to forward rate agreements, market participants expect that the 3-month euro LIBOR will be 4.70% in six months, compared to 4.97% today. Part of the reduction may be attributed to an expected end of the banking crisis, but it could also reflect a cut in the ECB refinancing rate. In any case, a further rate hike is highly unlikely. **Euro area bonds - in the 10-year range Bunds yield 4.02%, Italian BTPs an astonishing 4.73% - are thus well supported from a cost-of-carry point of view**.
20. **European stock markets are another matter. For the time being, the outlook for corporate earnings continues to deteriorate**. Recessions usually lead to a significant decline of profits as output as well as output prices drop, or rise only very slowly, while the cost base can not be adjusted quickly. The consensus view, based on broker research, calls for an earnings increase of 4.7% y/y in 2008, and 12.3% in 2009 (for the DJ Euro Stoxx 50). This will certainly be wrong. By definition, brokers are unable to predict falling profits.
21. **No, corporate earnings will be down by about 10% y/y this year, and by something similar in 2009**. Since I do not see evidence of a cyclical turning point in the euro area economy yet, I am uncertain about the timing of a rebound of stock markets. Note that these have been deteriorating in spite of the recent weakness of the euro – the depreciation of the currency will obviously bring forward the turning point.
22. **Has the euro depreciation ended?** The dollar is presently well supported by the improvement in the US balance of trade, and the expectation that falling oil prices will accelerate the process, ie reduce the supply of dollars in foreign exchange markets. The greenback is also seen as an investment alternative to commodities which are quickly falling out of favor. One cannot earn interest on oil and thus needs the expectation that prices will

rise to invest in it. Last but not least, the professional investor community has been long the euro year after year and must have been waiting to take profits at some point.

23. **I don't think the euro will fall much below \$1.40. America still needs capital inflows of about \$60 bn per month as a compensation for the trade deficit.** Bonds, money market instruments and equities are all considerably more expensive than their euro area equivalents and generate smaller cash flows. So it is not a foregone conclusion that foreigners will accumulate further dollar assets. The exception may be real estate. But prices for US houses and commercial property will probably fall some more because of a supply overhang and tight credit markets. So why buy now?
24. On the other hand, Europe's miniscule current account deficit means that the euro is not exposed to much selling pressure from this corner of the balance of payments. Last but not least, **I fail to see why the US should be a safer haven than the euro area** – just compare the stance of monetary and fiscal policies, or the situation of the financial sector. By year-end, the euro will be back at \$1.50.
25. **Two other weak spots of the world economy are the UK and Japan.** Both have suffered from commodity-related purchasing power shocks - much-higher-than-expected consumer price inflation has led to sluggish real income growth.
26. **In Britain the purchasing power shock has been exacerbated by the sharp depreciation of sterling against both euro and dollar.** Additionally, house prices are in a free fall. For many years people had happily sold their homes to one another, climbed up the property ladder in the process and felt richer and more creditworthy all the time. This had created a bubble which in turn had boosted household consumption, long the main driver of the economy. The bubble has finally burst.
27. Tight credit conditions, a crisis in the all-important financial sector and falling house prices combined with high levels of debt will prove troubling for at least one year. According to the EU Commission, **Britain's real GDP will decline at quarterly rates of 0.2% in the second half** of this year, following the stagnation in Q2.
28. **In the end, exports and the reversal of the purchasing power shock (ie lower consumer price inflation) will come to the rescue.** It will not be easy: household balance sheets have to be repaired which, as new have seen in Japan, can not be achieved quickly, and the rest of the world is not precisely waiting for British exports. Fiscal policies will not be of great help either, given that the budget deficit will probably reach 3.8% of GDP this year.
29. **Sterling has to fall further.** For some analysts the fact that this is possible, especially vis-à-vis continental currencies, shows how wise it was for Britain to stay outside the European currency union. Once inside, such a (competitive) depreciation would not have been possible. The flip side, of course, is that sterling has once again become a soft currency which has all but lost its status as a reserve currency and the advantages that come with it.

30. **Japan's real GDP has shrunk at an annualized rate of no less than 3.0% in Q2.** It looks as though it is heading toward recession. With export prices +0.9% y/y in August, and import prices a staggering +27.1% y/y, the terms of trade shock has been extremely severe. Seen from a different angle, consumer prices which reflect what people buy were +2.0% y/y in August while the prices of what Japan produces, the GDP deflator, were -1.5% y/y in Q2.
31. Moreover, **employment has declined at an annualized rate of no less than 2.1% since last January.** Consumption is therefore even weaker than usual. At the same time, exports to the US and Europe are down steeply, by so much indeed that China and the rest of the dynamic Asian region can not nearly make up for the shortfall. Declining commodity prices are now improving the situation, but the downward momentum will not easily be stopped. **Japan is in a mild recession. The stock market, 20% down so far this year, will not easily rebound.** Note that it is still almost 70% off its end-1989 level. The balance sheet recession drags on.
32. **Why is the yen so strong?** Not long ago, one euro had cost 165 yen, today it can be bought for 150 yen. Since the middle of August, the yen has even appreciated against the super strong dollar. The key factors are certainly not attractive interest rates – 3-month LIBOR is at 0.89, 10-year government bonds yield a more than modest 1.53% -, nor a buoyant stock market. The risk premium of the Nikkei 225 index has reached 7 percentage points, which looks rather attractive.
33. What we see is most of all an **unwinding of the so-called carry trades** where yen liabilities were obtained at low interest rates and then invested in higher yielding Australian, New Zealand and emerging markets. Since all of these have been extremely weak for a while, the game is up and the currency is coming home.
34. **The yen also benefits, as always, from Japan's current account surplus** (3.8% of GDP in 2008) as well as from the assumption of investors that the global financial crisis has more or less bypassed the country. It is my impression, though, that Japan's banking sector has its own serious financial problems and is once again in a costly deleveraging process. On the face of it, risk aversion, measured in terms of spreads between the 0.5% policy rate and a 3-month LIBOR rate of 0.89%, or between 10-year JGBs of 1.53% and swaps of 1.65%, is less pronounced than in the US and Europe, but this is probably simply due to the much lower level of interest rates. Overall, Japan's international price competitiveness remains excellent. In the coming dollar correction, the yen will test the 100 yen per dollar resistance level (105.66 today).
35. **So, after all these pretty depressing analyses, what can we expect from China, the world's new power house?** All forecasts I have seen are rather upbeat: growth is about to slow, as exports to the OECD area will not do well any more, but domestic demand will largely fill the gap. Real GDP had expanded by 11.9% y/y in 2007; at present, annualized growth rates are more like 8½% to 9 ½% which is still streets ahead of any other emerging market economy and certainly more sustainable than previous growth rates.
36. **The latest statistics** on industrial production – 12.8% y/y in August, and two seasonally adjusted monthly declines in a row, after around 18% y/y only a few months ago - **confirm the slowdown**, just as the fall in consumer price inflation – from 8.7% y/y in February to 4.9% last month.

37. Chinese monetary policy makers have gained room to become more growth-friendly again. **The transition from an export and private sector capital spending-led growth pattern to one relying more on household consumption will cause frictions which are bound to affect the labor market.** The fact that the trade surplus has still been close to record levels recently (\$28.7bn in August) was mostly due to weaker demand for industrial metals and falling commodity prices (which is another sign that China's boom is cooling off). To be sure, exports are still very robust and continue to make life hard for foreign competitors (34.4% 3m/3m saar).
38. **Stock markets have been in a free fall.** The Shanghai Stock Exchange Composite Index has dropped 60% since the turn of the year. While it is still 105% above its recent low of June 2005, it is clear that the bubble has burst and valuations have become more realistic. It also means that the cost of equity has increased steeply.
39. What is happening? For me, the most plausible explanation is that China had experienced an **overinvestment boom**, driven by an undervalued exchange rate and an extremely high savings rate, ie cheap long-term funds. The exuberance is now gone, for several reasons: the exchange rate has been appreciating since mid-2005 (from 8.28 to 6.84 per dollar), the returns on investment had steadily declined over the course of the capital spending boom - not least because any such boom invariably leads to resource misallocations and thus to overcapacities in certain sectors, for instance in steel or housing -, and the world economy is in near-recession.
40. It is clear that China's **demand for commodities will no longer expand at those blistering growth rates of the past.** The same holds for other emerging markets. Combined with the outright decline in OECD demand for oil and other raw materials (which was triggered to a large extent by the previous explosion of commodity prices), the downward pressure on prices will persist for a while. The main stabilizing factor will be the stepped-up spending on infrastructure in the non-OECD area – government finances in this part of the world are very sound.
41. According to OPEC's Monthly Oil Market Report, **global oil demand in Q2 (85.66 mb/d, or million barrels per day) has been 0.3% less than in 2007.** While OECD demand was down 3.0% (to 47.7 mb/d), the rest of the world was up 3.4%, including China which increased its demand by 7.5% (to 8.16 mb/d). Unsurprisingly, higher prices have left their traces. Even in oil-addicted North America, demand has fallen (by 3.0%).
42. **How far can oil prices fall?** Brent has reached \$92.64 today which is 36% below the peak in July. Even at this level, prices are very high, and demand is not going to pick up any time soon. I would not be surprised to see them go down to \$70 before year-end. Note that the 15-year average until early 2003 has been \$20. The long period of low and stable prices had ended only five and a half years ago.
43. **The other commodity prices, as well as food prices, are also correcting – and will continue to do so, given the state of the global economy, and industrial production in particular.** Prices of some key commodities are also pushed down from the supply side; high prices have led to an increase in capacities. **Copper** has lost 19% from its recent all-time high, but is still 300% above its level five years ago. **Nickel** prices have been on an even more extreme roller coaster. They have come down no less than 64% from their peak in May 2007;

but even so, they are more than 200% above their 2002 levels. The recent price decline partly reflects the expectation that the steel boom has ended and that 7 to 10% annual global growth rates are a thing of the past, at least for the time being.

44. **Russia has been severely hit by the collapse of commodity prices.** While these are still very high, the cost of production is rising in the order of 30 to 40% annually. For a long time this was not seen as a problem because output prices had increased at even higher rates. But revenues are now growing by much less and have started to fall in some sectors; the point where revenue curves intersect cost curves is drawing closer. It is clear that costs can not continue to rise as quickly anymore.
45. It is also clear that **imports - which were up 74.1% y/y in the three months to July - can not maintain this momentum.** They will have to slow considerably. Incidentally, exports were up just as much as imports (72.4%), and the average monthly trade surplus was an unprecedented \$20.2bn. Foreign reserves hit \$600bn as the central bank intervened to stop the rouble from appreciating as a result of these surpluses.
46. **For more than five years, Russia was in the enviable position that real disposable incomes were rising five or six percentage points faster than annual output (real GDP).** Living standards were improving quickly. This was the terms-of-trade shock in reverse. Now Russia will be at the receiving end of commodity price developments, and I wonder how it will cope. To be sure, price levels, as shown above, are still rather high, and the balance of trade surplus need not disappear overnight. In July, exports were still about twice as high as imports.
47. **But a rapid reduction of import growth rates is almost inevitable** – when export prices fall while import prices continue to rise, even if moderately, real disposable income growth falls below the growth rate of real GDP, perhaps to something like 2 to 4%. This is still quite nice, but for people who are used to raising their consumption by 14% annually this may look like a recession.
48. **The outlook for Russian consumption and growth has thus deteriorated. But the outcome must not be a recession.** For one, real net exports – which had been the main drag on growth over the past years – will turn around and become one of the economy's driving forces. The government will also step in and boost spending and/or cut taxes; the budgetary situation remains very sound. Spending on infrastructure, health, education, research and social benefits is still underdeveloped, partly because so much money seeps away because of corruption.
49. **The depreciation of the rouble is a good thing because it improves the country's international competitiveness – in a world of falling commodity prices real exports have to rise faster and real imports should grow by less.** There is some capital flight going on at this point as both Russian and foreign investors are scared by unpredictable government interference and the political isolation of the country. Is Georgia just the overture to a take-over of the Crimean peninsula? Foreign reserves have declined by almost \$30bn in recent weeks, in spite of the still very large trade surplus. This has the – desirable - side effect that money supply and liquidity growth will slow which helps to bring down inflation. The latter continues to run in the order of 15% at the consumer level, and about 30% at the producer level.

50. **Russian rouble denominated bond markets will remain weak as risk aversion has risen;** it is also no longer supported by the expectation that the rouble will appreciate. Yields have to rise above the inflation rate at some point. Part of the increase in real yields will come from a fall in inflation expectations.
51. **Equities are very cheap under the assumption that corporate earnings can hold up.** This may be the case, or it may not. On a trailing basis, the price-to-earnings ratio of the blue chip RTSI\$ index is in the order of 6 1/2. The outlook for profits depends crucially on cost control. Those firms which can be expected to do well on this front can be very attractive indeed. Another obvious choice would be those that benefit from government spending. Investors have to be very selective. There is no rising tide any more that lifts all boats. But it is precisely in situations like these, when news is so negative, that the basis for a superior performance is laid.

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