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Wermuth's
Investment Outlook

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1. As the panic in financial markets spreads to all corners of the world, and increasingly affects the real economy, prices of many real and financial assets have fallen to very attractive levels. For investors who have a cash surplus, who have avoided borrowing against collateral whose value has collapsed, **there are plenty of once-in-a-lifetime opportunities. As it is, there will be even more once-in-a-lifetime opportunities tomorrow.**

2. While it is likely that the banking industry will survive the crisis, if only at the price of partial or full nationalization and government restrictions on business, **the real economy has just started to contract.** With stock markets down between 30% and 65% this year, and real estate bubbles bursting not only in the US, the UK and Spain but in key emerging markets as well, negative wealth effects will lead to downward revisions of spending plans.

3. Additionally, demand for goods and services will suffer because **the global deleveraging process is gaining momentum.** Firms and households had often borrowed on the assumption that their income stream was not only safe but rising, and that the value of their equities and homes would continue to rise or, in a worst case scenario, decline by maybe 30%, and that only temporarily. The awakening has been rude. **Borrowers have been forced to repay their debt in order to maintain solvency which in turn has led to further asset price declines.**

4. **The rescue packages for the banks will slow the deleveraging process and thus prevent a deadly downward spiral, but they do not solve the problems caused by the discrepancy between bombed-out asset prices and debt service requirements**. Obligations vis-à-vis lenders have not declined in step with asset values. To reduce them will take years of robust corporate earnings and household incomes. In Japan, the deleveraging process, the return to financial soundness, has taken more than a decade (and stock prices are still only at 22% of their end-1989 level!).

5. **Banks will certainly remain rather risk averse for a while.** They see that unemployment is rising, that corporate earnings forecasts are revised down, and that micro and macro growth forecasts are reduced all the time. They will thus hesitate to lend generously. The capital injections from the government help to improve their capital ratios, but are probably only a first step. Many of the global banks, especially the investment banks, had operated with an equity base that amounted to less than 3% of their unadjusted assets (if one includes off-balance sheet assets). They were de facto hedge funds.

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6. One obvious conclusion is that **central banks will be asked to accelerate the deleveraging process by cutting interest rates.** The banking sector as a whole can not make money from its traditional business model, borrowing short and lending long, if the yield curve is inverted. But this is still the case.

7. In the US, 3-month LIBOR is at 4.55% while 10-year swap rates (which represent bank risk) are 4.52%. The yield curve is therefore more or less flat even though the policy rate, ie the Fed funds rate is only 1.5%. Banks do not trust each other yet. **In order to bring down 3-month and other inter-bank rates to levels where banks are able to make money and become more generous in their lending the Fed will not only have to supply a lot of liquidity, it will also have to cut the funds rate to 1% and less. The Bank of Japan is the role model.**

8. **In the euro area the yield curve is actually negative**: 3-month EURIBOR is 5.17% but 10-year bank bonds yield only 4.68%. The ECB has long been in a state of denial in the face of the financial crisis. Until last week, the main focus had been on getting down headline inflation; it had hit a high of 4.0% y/y in the summer. Since this had been way above the target of 1.8% or 1.9%, the ECB was afraid inflation expectations were getting out of control. On July 3, the main refinancing rate was therefore raised by 25 basis points, to 4¼%.

9. In last week's international emergency action, it was cut to 3¾% even though consumer price inflation is still at 3.6%. This **cut will not be the last, given the persistence of the yield curve inversion.** I would not be surprised to see the refinancing rate at 2% before year-end. Government bonds are certainly well supported from that side.

10. It is a safe bet that **rate cuts are not inflationary in the present environment.** As long as the deleveraging process continues demand will be weak. It is therefore difficult for business to raise prices. This is true for all main economies, including emerging markets. Even high wage inflation is not really dangerous at this point – in the early stages of a recession, it will typically lead to lower corporate profits, not higher consumer prices. Later on, as unemployment rises, wage inflation will disappear altogether. Central banks will therefore have no problems explaining why they reduce rates in the face of above-target inflation.

11. **At its core, deleveraging is deflationary and therefore extremely dangerous from the perspective of central banks.** Assume consumer prices and inflation expectations fall to minus 2% y/y, while government bond yields drop as well and reach +2%. The resulting real bond yield of 4% would therefore be a very good deal. Even holding non-interest bearing cash would not be bad when the general price level is in retreat. The central bank would not be able to stimulate demand and bring back inflation into positive territory in such a situation (except by swamping the economy with base money). For Japanese, all this sounds very familiar.

12. **Speedy action on part of the ECB and the Fed is therefore crucial – before deflationary attitudes take hold.** If central banks succeed, they have also increased the probability of a fairly early economic turnaround. The new forecasts of the IMF or the German economic research institutes for global output growth next year are downbeat, and the risks are said to be clearly on the downside. **According to the IMF, world output, at market exchange rates, will rise by just 1.9% y/y in 2009. This can already be called a recession, but something more apocalyptic can not be excluded.**

13. **Another stimulus for the world economy will be falling energy and other commodity prices**. Just as the booming global economy had led to a shift of the demand-for-commodities curve to the right, the looming recession is already pushing it back to the left. The supply curve is as steep as ever and does not move much over a year or two. This is particularly true for the oil market, but also for any other commodity market where the lead time between initial investment and the start of production is long. This means, prices can fall just as fast as they have increased since 2002. An oil price of $30 is no longer out of reach. Metals and food prices are plummeting as well.

14. This means that **the terms of trade of the energy and commodity importing countries are improving rapidly.** The large deterioration of OECD countries' terms of trade had been responsible for the collapse of purchasing power and weak household demand. For a couple of months now, real disposable incomes are already rising faster than real GDP. Private consumption will get a boost from this effect.

15. **A third factor that helps to prevent the global recession spinning out of control is fiscal policies.** There is presently no alternative to more stimulative government spending, in combination with falling taxes and rising outlays for social benefits as economic activity slows, ie the so-called automatic stabilizers. The rescue packages for the financial sector will have a limited direct impact on final demand – their main effect is to avoid a meltdown of the system.

16. More must be done. As the recessions drag on and output gaps widen, **governments have to come in as substitute buyers.** In Japan, the government deficit had at one point reached 8% of GDP without, incidentally, negative effects on inflation and bond prices. This is the benchmark.

17. **Finally, there is a natural limit to where asset prices can fall**. In housing, new construction is nearly grinding to a halt in key countries. Low prices, falling mortgage rates and the rising trend of household formation will at some point lead to a stabilization and then a recovery of the demand for homes.

18. **Stock prices are another matter.** Downward revisions of earnings forecasts will dominate the news for at least another year. In a long and deep recession, companies lose money and may therefore not necessarily be cheap, in spite of previous large declines in their stock prices. The stabilizing factor is the accelerator principle we know from Economics 101 – a turning point is near when the downward momentum of output finally slows, while inventories have been adjusted to a depressed level of demand. Typically, at such a juncture, interest rates are so low that it costs very little to finance and thus to rebuild inventories. And off we go.

19. Perhaps. Right now, there is no evidence of this yet. Government bonds are the safer bet. If I had **to reshuffle an equity portfolio I would buy financials and stocks which benefit from falling energy and commodity prices, and government spending. I would shun commodity producers, cyclical consumer goods, and capital goods.**

20. As to exchange rates, it is somewhat of **a puzzle why the euro has lost so much against the dollar (more than 15% since the summer high)**. Note that the yield spread of 10-year US Treasuries against 10-year Bunds has virtually disappeared – only a few months ago, Treasuries had yielded about 50 basis points less. Bunds are a safe haven, but the euro is not.

21. Moreover, **euro area money markets are in better shape than US money markets** and thus a safer place: the spread between 3-month Treasury bills and 3-month LIBOR (the TED) is 428 basis points whereas the comparable difference between 3-month Euribor and the so-called Bu Bills of the same duration is "only" 349 basis points. In reality, of course, neither of the two money markets is functioning at this point, in spite of all the efforts of governments and central banks.

22. **One explanation is that market participants seem to believe that the euro project is endangered.** Evidence of this are the large spreads of Greek, Italian, Spanish and even French bonds over Bunds (84, 69, 46 and 20 basis points, respectively, in the 10-years). The US has an effective crisis management, markets seem to say, with the Fed, the Treasury and the regulator (FDIC, SEC) working closely together and all able to act decisively.

23. In the euro area, there is nothing of the sort. The **ECB can stabilize the price level and inflation expectations but it cannot prevent a systemic crisis, ie rescue banks.** What again is the telephone number of the euro area finance minister? The euro urgently needs the support of a strengthened euro group (of finance ministers) and a banking regulator associated with, or even supervised by, the ECB. The 15 EMU-countries have to get their act together. There is no chance that the Commission which represents all 27 EU member states will ever be able to do anything in the area of financial market stabilization.

24. On the basis of the fundamentals, the euro should be the currency of choice these days. It is not. Even so, since the depreciation has been so massive and since the fundamentals are healthy, at least in relative terms, I would guess that we are near the bottom of the curve. In the meantime, the **euro's weakness has considerably improved the euro area's international price competitiveness** and is thus rather welcome from a near-term or cyclical point of view.

25. A few concluding **remarks about Russia**: there has been a lot of leveraged buying of equities by banks and the notorious oligarchs, and more private sector borrowing in foreign currencies. Both had been tempting strategies given easy monetary conditions and an appreciating currency. Now the bill has to be paid. Collapsing commodity prices have exerted downward pressure on the stock market and thus on the value of collateral.

26. Given the risk aversion of foreigners regarding anything Russian – evidence of this is the decline of currency reserves from $600bn to $540bn within just a few months -, the rolling over of non-rouble debt has become very difficult and has forced the government to provide support. At the same time, margin calls are forcing Russian investors to off-load their equity portfolios at almost any price. It seems that **the process has not yet run its course.**

27. Another troublesome development is the reversal of the terms of trade. Real incomes have begun to expand by less than real GDP (which until recently had been growing at a rate of about 7%) which means that living standards are not improving any longer, at least not until energy and commodity prices stop falling. So far, **costs at the major energy and metals**

producers have been rising at rates of 30 to 40% y/y. Now that revenues from exports as well as domestic sales are declining, profits are coming under serious pressures.

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