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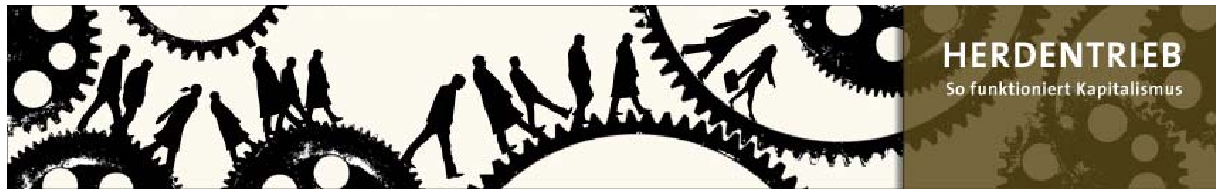

Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

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1. It is tempting to point out that prices of most stocks, corporate bonds, properties and commodities are extremely low and that these assets are therefore very attractive buys. On the other hand, long duration bonds of OECD governments look expensive and should be sold. For investors who are cash rich or are still able to borrow long-term money, **the world is full of opportunities. Or is it?**

2. **The question is whether the factors that are stabilizing the global economy will be strong enough to end the deleveraging processes**, ie stop the increase of savings rates and cash holdings, and the repayment of debt. If that were the case, markets would quickly sense it and launch a recovery. Historical evidence suggests, however, that repairing the balance sheets of households, banks and non-financial corporations may take very long, depending on how low the ratio of own to borrowed funds actually is. The lower it is, the more time it takes to return to previous GDP growth rates.

3. **The past two decades have been characterized by low inflation and easy monetary policies.** Emerging markets exported price stability to OECD countries, on the back of cheap and abundant labor and artificially undervalued exchange rates. This in turn enabled policy makers to pursue easy monetary policies. During what is now called "the great moderation" central banks, especially the Fed, were less concerned about asset bubbles and rather focused on headline inflation – which was low -, on avoiding recessions, and – after the end of the dotcom bubble – on preventing deflation. Risk premia fell to very low levels, and optimism reigned. The good times were expected to last forever, more or less.

4. As in the case of Japan twenty years earlier, the economic environment was seen as so favorable by market participants that they were little concerned about their debt ratios. **In the US, just as in Spain, the UK, the Baltics, Ireland, Hungary or Ukraine, to name just a few, the purchase of assets had been more and more on the basis of borrowed money.** Now the chickens are coming home to roost. Asset prices have collapsed – because at some point, at elevated price levels, expected risk-adjusted returns on real estate, stocks and so forth fell below the cost of borrowing.

5. **By now, avoiding insolvency has become the top priority for those who have suddenly realized that they are over-indebted. To get off creditors' hooks, spending on everything non-essential is being slashed. The deep recession that is now unfolding on a global scale has been the inevitable result of this drop in demand.**

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6. **What are the stabilizing factors? Is there hope that the contraction of output will come to an early end? To begin with the conclusion, it looks to me that we are still only at the beginning of the crisis, in spite of the huge price corrections that have already taken place.**

7. **First, the steep decline of prices for oil and other raw materials helps.** It is putting money back into the pockets of consumers in commodity importing countries. In real terms, they have now more money to spend – inflation will be lower than expected. In the euro area, for instance, the seasonally adjusted consumer price index has been stable for four months in a row while wages continue to rise at more or less the same rate as before. In the US and Japan, the situation is similar. Mr King of the Bank of England expects headline inflation to reach 1% sometime next year, down from 5.2% in September. Going by the recent fall of import prices, the outlook for inflation and thus households' purchasing power could not be better.

8. Cost reductions for business due to lower commodity prices are also significant and will soften the blow on profits that is caused by weak final demand. Do not expect too much from these effects. I suspect that for the time being most of the additional income will be used to reduce debt rather than to boost consumption and capital spending.

9. **Second, it also helps that the ongoing increase in output gaps – another way to say that there is a recession - is accompanied by falling inflation rates. This gives central banks more leeway** than usual to cut interest rates and stimulate the economy – lower interest rates discourage saving and boost borrowing and spending. The Fed has already arrived at 1%, the Bank of Japan is once again near zero, the Bank of England has signaled that rates will be cut in quick succession from their present level of 3%, presumably also to something close to zero over the next half year. Even the foot-dragging ECB has indicated that rates will be cut aggressively – on December 4, the main refinancing rate will probably be reduced to 2¼%. More is to come. China is in an easing mode as well.

10. **Low interest rates are necessary but not sufficient to get the economies going again.** One problem is that rates cannot go below zero. In a genuine deflation the interest rate tool becomes ineffective. Assume that inflation moves from +2 to -2, and that the policy rate remains at 0% - in real terms it increases from -2% to +2%. In a recession, this has a massive contractionary effect and the opposite of what is needed. At some point, central banks will be forced to swamp the economy with base money, ie lend directly to the private sector and buy government debt. As the Japanese experience has shown, even this will not necessarily lead to more final demand as long as the deleveraging process is not yet over. Even so, easy monetary conditions are an important stabilizing factor in this crisis.

11. **A third line of support is fiscal policies.** Most governments have not yet fully realized that they have an important role to play in keeping this recession short and shallow. The rescue packages for the financial sector have already been a drain on the public purse, a not very popular one for that, so they hesitate to contemplate additional stimulus programs. It is clear that the private sector is cutting back on consumption and investment, that unemployment will begin to rise steeply (in the US, this is well under way already), that spending on social benefits will increase and that tax revenues will be up by less than last year. Budget deficits are therefore on the rise in any case, and a government such as the German one is embarrassed that it will once again miss its balanced-budget target and thus needs some strong prodding to act in a decisive manner.

12. **But there are times for fiscal rectitude, and there are times for largesse.** If the private sector goes on a spending strike because balance sheets need to be repaired and because borrowing money is no longer easy, it is the task of the government to at least partially fill the gap in demand. Given the severity of the crisis, the public sector will have to accept swings in its budget balance of four percentage points or more. Only the US seems ready to accept such a dramatic deterioration of government finances. Deficits will widen in any case, so in order to shorten the recession it is better to act early and set the right priorities (subsidizing the auto industry indiscriminately is about the worst in policy making we have witnessed in a long time).

13. **As it is, I expect the sense of urgency to build with each new economic forecast and each catastrophic labor market statistic. For now, fiscal policies are not yet in the act of fighting recession. Their contributions are still negligible.**

14. **Fourth, there is the exchange rate.** For the world as a whole, currency movements are a zero sum game, but for the UK, the euro area, Russia and a large number of other emerging markets recent substantial depreciations are beneficial in the sense that they have improved the international price competitiveness of their economies and thus boost GDP growth. One drawback needs to be mentioned, though: a weakening of the real exchange rate reduces the purchasing power and thus household consumption. In commodity importing countries this reduces the positive effect of falling energy, food and metals prices.

15. **On the other side of the equation are Japan, the US and China whose exchange rates have appreciated a lot this year.** They have become less competitive internationally but their domestic demand will be boosted by the strong improvement of their terms of trade. On balance, though, the appreciation's negative effect on growth will be stronger than the positive effect from a rapidly falling inflation rate.

16. **For the US, the strength of the dollar means that the reduction of the balance on current account deficit (4.6% of GDP in 2008) and thus the shift from domestic demand to foreign demand will take longer. The world's main imbalance will thus persist.** In other words, the US remains the largest net importer of capital as far as the eye can see. New currency crises are almost inevitable if the dollar stays as strong as it is.

17. Incidentally, this is in **stark contrast to what will happen to the other large rich-country capital importer, the UK**. There, the administration is almost pursuing a policy of competitive devaluation to kick-start the economy: given Britain's deflationary forces, the risk is almost negligible that sterling's devaluation will lead to above-target inflation rates. So this is an opportune time to wean the economy off its reliance on housing, financial services and imports – which had to happen in any case, and the sooner the better.

18. **To sum up, countervailing forces are not yet strong enough to prevent a global recession. It is likely that the sense of urgency will increase, as it must, but up to now it is too little too late. The governments in particular are called upon to stabilize demand. Hopefully, they will not simply revert to populist activism. The crisis is, as always, also an opportunity, in this case to boost the long-term growth potential, to do something for the environment and to correct the income distribution which has become more uneven and unjust.**

19. **So what should investors do?**

20. **One obvious safe-haven strategy is to increase the share of government bonds in currencies which are undervalued.** The best candidates are long-duration euro area bonds of countries such as Greece, Italy, Spain or France. The euro has retreated significantly and will inevitably bounce back some time soon. The fundamentals are sound, and the only problem I see is the suspicion of investors that the euro area may fall apart under the strains of the crisis. In the treaties there is no explicit bail-out clause for weaker countries.

21. On the other hand, even the weak members have unrestricted access to the Eurosystem's funding facilities, at the same cost for all. Moreover, the cost of giving up the euro is prohibitive, especially with regard to debt service. The euro will survive, and the present developments will necessarily lead to closer cooperation in fiscal policies and banking supervision.

22. The weak euro is a boon for the economy but it has also driven home the point that a currency union needs more than just a central bank charged with looking after price stability. Financial stability is at least as important to assure the survival of this grand project. That said, I think **investors can not do much wrong by shifting a larger part of their funds into non- German euro-denominated bonds** – in the 10-year range they yield 31 (France) to 150 basis points more than Bunds whose yield is presently 3.64%. All these bonds are not only well supported by the outlook for the exchange rate but also by the ECB's coming rate cuts. **US Treasuries are at 3.81% and also a safe proposition,** except that they may suffer from the coming dollar depreciation. For diversification reasons alone, they are a must, however.

23. **Will commodity prices fall further? The main message one gets from long-term time series is that there has been an almost unprecedented bubble which has now popped, but that price levels are still well above the trend line.** Have a look at oil, copper, aluminium, wheat or gold. Commodities are, by definition, simple products and can be found and produced at will, depending on price signals. That is even true for oil. There is no inherent reason why the relative price of commodities should rise over time.

24. **China**'s rapid economic growth has long been the main support for commodity prices. In the meantime, the situation has deteriorated there. Exports are suffering from the recession in the OECD area, the construction sector looks overheated and is now in a correction phase, while industrial production seems to contract on a month-over-month basis. The crash of the stock market and the huge fiscal stimulus program are signs that the go-go era is over, at least for now.

25. So I would not yet go back into this asset class but rather **wait for prices to fall below their pre-bubble levels.** One commodity I would certainly short in this potentially deflationary world is gold. With oil, the balance of risk remains on the downside as well.

26. **The major stock markets have lost between 33% (Dow Jones Industrials, FTSE 100) and 62% (China) since the beginning of the year. Are equities therefore cheap?** In general, on the basis of four-quarter trailing per share earnings, some look still expensive: the p/e ratio for the S&P500 is still 19.6, for the NASDAQ it is 30.2, and for the Swiss Market Index no less than 38.2 (caused by huge losses in banking). If consensus forecasts of next year's earnings prove to be correct, we get the following, more reasonable p/e ratios: DJ 11.3,

S&P500 11.9, NASDAQ 16, FTSE100 7.3, EuroStoxx 50 7.4, DAX 8.3, SMI 9.9, Nikkei 225 13.1, Shanghai 12.7.

27. These numbers must be put into perspective – what is the earnings yield of these stock markets compared to the real yield of riskless long-term bonds denominated in the same currency? **Under the assumption that inflation expectations in the US, the euro area, the UK and Switzerland will soon fall to 1½%, we get the following risk premia** (percentage points over real bond yields): DJ 6.5, S&P500 7.3, NASDAQ 5.2, FTSE 100 11.1, Euro Stoxx 50 11.5, DAX 10.0, SMI 9.1. Under different inflation assumptions, the risk premia for Japan and China are 6.7 and 6.9 (warning: the calculations for these two markets may be far off the mark).

28. **While the numbers for the US suggest that valuations are mildly attractive from a historical perspective, Europe's markets are outright cheap. They usually are, though**. In addition, if the euro really bounces back, the earnings outlook will deteriorate again. But even so, investors can not do much wrong by paying more attention to European stocks.

29. **The main risk is that corporate earnings will not stabilize as early as forecast by analysts**. They once again bet on a brief recession. Their assumption is that economic policies will be effective. They may also assume that the sheer "weight of money" will force investors back into equities - in other words, after an extended period of de-investing the normal inflow of savings will create a pile of cash that waits to be invested. This may well be the case at some point, but I am fairly sure that deleveraging will last for at least another year – the cash thus goes into debt reduction, not new long positions in equities.

30. **Some final remarks about the situation in Russia: t**he main stock market index has lost 73.9% since May 20. It trades at a trailing p/e ratio of 3.3, and of 2.9 on the basis of current year earnings. None of the other large emerging stock markets is so cheap, nowhere are risk premia so high.

31. **There are at least three reasons for this sell-out**: the crash of commodity prices, confrontational policies since the war with Georgia, and an explosion of costs (until recently, they have been running at rates of about 35% y/y). In spite of huge foreign currency reserves and one of the world's largest current account surpluses, investors are deserting Russia. The central bank, by defending a dollar/euro currency basket rate, has been forced to sell reserves which are melting away quickly. Another response has been to raise interest rates. Even so, the rouble has depreciated by 15% against the dollar since the middle of July – against the euro, it has actually appreciated by 6.0% over that period.

32. **One problem is that Russia's private sector had borrowed foreign currencies to the tune of half a trillion dollars.** At the same time, Russia has been a net exporter of capital which means that not only the central bank but also the private sector must have exported capital. On a net basis, private sector foreign currency debt is probably quite manageable, but in practice, the capital importers and capital exporters are different entities, it seems. Since the value of the collateral used for borrowing abroad had collapsed, Russian borrowers were forced to sell the assets they had to meet their obligations vis-à-vis foreign lenders. This drove down stock markets even more, and presumably also real estate markets. Not to forget, repaying foreign debt also increased the demand for dollars and thus put pressure on the rouble exchange rate.

33. In this situation, **the CBR has only unpleasant options**: one is to **let the rouble float** which would lead to a steep devaluation, but would also cause a wave of bankruptcies (in rouble terms, foreign debt would increase correspondingly); on the other hand, it would be precisely what the doctor would prescribe for a country with an overvalued currency and capital flight. The devaluation would reduce imports and thus prevent a swing in the balance of trade from large surplus to large deficit. The deterioration in the terms of trade would obviously reduce domestic living standards which are already under pressure since commodity prices have begun to nose dive. For a government which had delivered strong economic growth for a decade, this could pose some danger.

34. **Pushing up interest rates to turn around capital flows would have pretty much the same effect on the economy and is thus also a rather unpleasant alternative.**

35. **The other option is to introduce capital controls** and higher import duties. In the near term, these policies can be effective but they come at the cost of more bureaucracy, restrictions on the allocation of resources and thus slower productivity growth. Still, at the moment, they seem to be the most likely outcome.

36. It is understandable that foreign investors are not yet rushing back into the Russian market. The situation is very much in flux even though, politically, there is no backlash yet against the government. Average incomes are still very high compared to ten years ago. Since the summer, they have begun to rise by much less than previously. Real GDP growth is heading toward 3 to 4% which is still a decent outcome in a world plagued by recession. Russia benefits from the fact that there will always be a reliable demand for the commodities it produces.

37. But the present crisis has exposed the main weaknesses of the country – the dependence on volatile commodity prices, the concentration of power and wealth as well as endemic corruption. These are negatives which continue to make investors skeptical.

38. On the other hand, from an investor's perspective**, valuations are extremely attractive and provide a reasonable compensation for risks.** In terms of resources and compared to other emerging markets, Russia is well endowed and will, under normal circumstances, always be part of commodity and emerging market portfolios.

39. **Utilities remain a good bet because they will always have something to sell what people need, just as most commodity exporters. They benefit from the weak rouble. In general, the focus must be on those companies who can credibly show that they are serious about cost control and are not too much affected by the coming slowdown of domestic demand growth.**

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