



Wermuth's Investment Outlook

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by Dieter Wermuth^{*}

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1. **Let me focus on the positive aspects of the present crisis.** The forecasts which I see are all extremely down-beat. It is getting likelier by the day that global GDP will shrink for the first time in generations. For investors, it is important to note that we are not only witnessing a general slow-down of activity but also significant structural changes, and **while there will be many losers, there will also be winners.**
2. **The environment is one of them.** Even though the oil price has fallen from \$145 to somewhat below \$40 these days, compared to the \$20 average that prevailed in the 15 years until the end of 2002, it is still rather high. Together with the stagnation of global output this will result in a reduction of oil demand by up to 4% between 2008 and 2009. Prices of coal and gas are also still quite elevated, and their consumption will therefore decline as well. **This means reduced emissions of greenhouse gases.**
3. Moreover, a main plank of the economic stimulus programs announced on both sides of the Atlantic is the **promotion of energy savings and green technologies.** Cars will become more fuel efficient, houses will be better insulated, and renewable energy will be heavily subsidized. The US will get its first “green” president. All this will improve the environment, at least for a while. The environment is one of very few good investment stories.
4. For some observers, **the long rally of West European and North American government bond markets has created a new bubble. I don't think so. There is still room for further gains.** The main reason is that deflation is not unlikely any longer. So far, analysts could argue that the reduction of inflation rates has just been the pay-back for previous excesses, basically a reflection of commodity price movements, and that nothing much had happened to underlying, ie core inflation. This is true, but we are now getting beyond that point. In the US and in Germany, for instance, both producer and consumer prices ex food and energy have begun a gradual decline. Given the weakness of general demand, this new trend will probably accelerate from here on. In Japan, deflation has actually never ended.
5. Deflation is good for bonds of issuers whose ability to service their debt is not in doubt. Since there are no signs that global deleveraging, the strategy to reduce debt levels, will soon end, buyers, not sellers, are setting prices, thus pushing them down. As we have learned from Japan's experience, it takes a long time to correct previous debt excesses. Fear

^{*} 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.

of deflation, or actual deflation, will stay with us for some time. **Investors are thus forced to buy long-duration bonds. Before yields fall even more, they must make sure they have the assets that generate a steady flow of income which covers their obligations.**

6. Recall that in mid-2003, the yield of Japan's 10-year government bond fell to less than half a percent. This is where JGBs are heading once again today, but this time they are joined by US Treasuries (2.09% right now), Bunds (2.94%) and UK Gilts (3.09%). **Capital gains on Bunds will be in the order of 20% if yields do indeed reach 0.5%** at some point in this deflation cycle. Not a bad performance, considering the quality of the borrower.
7. **Oil consumers find themselves on the sunny side of things as well.** Today I saw that my gas station had reduced the price of one liter of premium to €1.029 - which is down no less than 55 euro cents from last summer's high. For the average driver who needs about 100 liters a month, his or her net income has thus increased by €55 or 1.7%. Heating oil prices have also come down steeply. This may explain why German consumers are relatively optimistic these days. It helps, of course, that unemployment has continued to fall so far, that they had not overextended themselves financially and have never been obsessive shoppers; their savings ratio has been more than 10% for many years. Incidentally, the impact on Americans' net income is even more dramatic, due to much lower gasoline taxes; prices for one gallon have come down from a high of about \$4.- to \$1.66 now.
8. I guess that **oil prices have not yet bottomed out.** They are still almost 100% higher than in the 15 pre-bubble years that ended in late 2002. There was a very informative graph on oil and its substitutes in the Financial Times of December 22 (p. 7). It shows at which oil price various fuel sources become economically viable. Conventional oil in the Middle East is profitable at \$30 a barrel, in the rest of the world at \$45, and from deep water wells at \$65. Unconventional oil from Venezuela's Orinoco Belt breaks even at \$30, while the profitable exploitation of oil shale starts at \$110, just as the transformation of coal into liquid fuel. Canadian oil sands kick in at \$95. Even the production of bio fuels from sugar cane, US corn or European feedstock becomes competitive at oil prices in the relatively low price range from \$45 to \$82. In electricity generation, oil is replaced by coal at \$70, or \$145 if the cost of carbon capture and storage is included. Onshore and offshore wind farms join the party at \$75 and \$145, respectively. Nuclear power comes in at \$145.
9. In short, given the huge size of alternative energy reserves, it does not make any sense to talk of an economically meaningful physical limit to the supply of oil. Forget all the talk about "peak oil". **At today's cost levels, oil prices will never exceed \$145.** On the downside, they can fall a lot: once production facilities for oil or alternative sources have been installed, there is pressure to keep them going. Marginal costs are typically rather low, so even at barrel prices of \$10 or less it is profitable to produce. The oil price inflation of the five and a half years to the summer of 2008 has caused a massive market reaction, not only on the demand side but also on the supply side. **Oil will remain plentiful.**
10. **The importers and users of oil will continue to benefit for the foreseeable future.** The present crisis may have started in America's housing market and its "innovative" investment banks, but another important cause has been the unprecedented explosion of commodity prices. Since this process has now gone into reverse, the purchasing power of

the users of commodities is rising steeply. It is one of the key forces that will eventually pull the global economy out of recession, if not deflation.

11. **Something similar has happened, incidentally, on the food front.** Prices there have collapsed in recent months. Food importers, processors and consumers all pay less than expected only a short while ago. Since there are globally 20 to 30 times more consumers than producers of food, the net effect on real incomes is overwhelmingly positive.
12. **One winner so far has been the euro** which celebrates its tenth anniversary on January 1. Slovakia is country number 16 – and the number 2 of the former communist countries - to join the monetary union. The currency is now legal tender for 325 million people. Inflation is lower than it had been in Germany before the euro's introduction, and the exchange rate goes from strength to strength.
13. **The euro benefits from the fact that the euro area is less affected by imbalances than the US, the UK or some of the large emerging markets.** To be sure, there are serious housing crises in Spain, Ireland, Greece, Portugal, and to some extent in Italy and France, but overall, house price inflation has been moderate. Between 2003 and 2007, residential property prices rose by an average annual rate of 6.3% while input prices, ie the cost of construction, averaged 3.7%. Spain and Ireland are in deep trouble, but since these two countries account for just 14% of the region's GDP, their problems look manageable.
14. Since, for the euro area as a whole, the government budget deficit has been about 1.4% of GDP this year, while the current account deficit has probably been 0.4%, policy makers' room for maneuver is fairly large. So far, announced stimulus packages have been in the order of 1½% of GDP which is considerably less than what the American and British governments are planning. The ECB is also proceeding relatively cautiously and is likely to skip the next opportunity to cut rates (on January 8). **All this reduces the risk that the euro will lose its value. It is certainly not yet official policy to fight deflation with all means available – with the printing press, for instance.**
15. **Even so, it is only a matter of time before European policies will become much more expansionary.** All leading business cycle indicators, especially incoming orders and business surveys, are steeply down since last summer. Deflation is not a remote possibility any more. Unemployment - which had bottomed out at 7.4% in June – will reach 9% a year from now, real GDP will continue to decline during 2009 and be down about 2% compared to 2008, and government budget deficits will rise sharply as a result. Moreover, the banking crisis is far from over. Look, for instance, at the 167 basis point spread between 3-month Euribor and 3-month (German government) "Bubills" (2.96% – 1.29%), or the 103 basis point spread between 5-year swaps, ie bank risk, and 5-year German government "Bobls" (3.23% - 2.30%). As long as the monetary transmission mechanism stutters, it is not possible to tighten policies.
16. In other words, **the euro is not strong because of sound fundamentals but because its fundamentals are not as weak as those of the others.** At some point, the appreciation of the euro will be seen as a problem, but probably not before it hits \$1.60 again. I am convinced that this point will be reached earlier than most market participants think.

17. **To continue with the list of winners in this crisis, savers are in general doing very well.** This includes countries which are running large current account surpluses such as Singapore, Norway, China, Switzerland, Sweden, Japan, Holland, Germany, or Taiwan, unless, of course, they have invested a large share of their foreign assets in equities, corporate bonds and real estate. In spite of this potential problem, they are still able to buy risky assets at very low prices now and will thus benefit in the long run, as long as they remain net capital exporters. On the micro level, savers who have put their money into traditional savings accounts, time deposits or government bonds not only receive a steady income now, the value of these assets actually goes up in the coming deflation. Even cash would gain in real terms! Nice as this is for the thrifty, for the economy as a whole it is negative and the opposite of what is needed.
18. **Pensioners who get their money from a pay-as-you-go system (as in Germany) or a defined-benefit scheme are also doing well in a deflationary world.** They are, as a group, better off than the young whose jobs are at risk and whose real incomes can be adjusted down by their bosses. This situation does not make for a dynamic society and is a drag on demand. As long as saving and repaying debt is seen as the best strategy, we will not get a recovery.
19. **Are there any cash-rich companies these days?** Since banks have raised lending standards a lot, they would be better positioned than others to take advantage of low prices, including asset prices. **Utilities** come to mind because they are mostly oligopolists, if not monopolists, and can set their prices. Everyone is forced to buy their products. Companies that sell boring but necessary stuff, such as food or do-it-yourself goods, should in general also be ok as long as competition is not too fierce.
20. **Banks will probably continue to struggle.** They have to strengthen their capital base, can no longer hide the riskier parts of their business in off-balance sheet vehicles, and have to reduce their leverage. Regulators will see to that – they do not like to be seen sleeping on their job any more and are therefore getting tougher, perhaps even too tough for the good of the banking sector. On the other hand, some of the more **conservative insurance companies**, with a large share in high-quality bonds on their asset side and steady premium inflow, have been punished too much by markets and could do well relative to the other segments of the financial industry.
21. **Corporate bonds have also suffered during the general sell-off of risky assets. They deserve a close look now.** Fewer issuers will go broke than risk premia suggest. Especially those firms come to mind which are too big to fail, or which are systemically important, for instance in the defense industry. Car companies are also top of the list: policy makers are scared to let them fail even though there are clearly excess capacities, and in spite of all the talk about a green future - which presumably means we should all be driving less. Because so many jobs are involved, economic sense must take a back seat, it seems.
22. Much of the money spent by governments to get economies going again will be for **infrastructure** projects and subsidies for improving energy efficiency. Construction companies, producers of buses, locomotives and other railroad equipment, of power plants, windmills, solar panels, thermal insulation and so on will benefit from this.

23. On balance, investors are not faced with a wide range of alternatives. Not everyone is content with those low yields of government bonds, or wants to bet on currencies or commodities. Some **reshuffling of assets along the lines described above still makes sense**. When the recession is over, the structure of the economy and therefore relative prices will be quite different from what they used to be. One can prepare for that.
24. **Equities are mostly much cheaper than in the past.** In Russia, for instance, the trailing price-to-earnings ratio of the main stock index is just 3.2, and the price-to-book ratio is 0.5! This looks very tempting. However, since the global recession shows no sign of ending yet, the news on earnings will probably deteriorate before they get better. Therefore, puts on the major stock market indices remain a plausible strategy. It is presently easier to identify assets which are too risky than to find strong buys. But it is also clear that this is the time when the basis for superior returns can be laid. Anybody out there who has the cash to start buying again?

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