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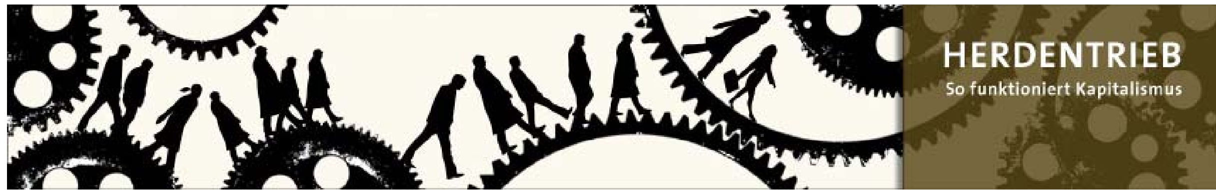

Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

by Dieter Wermuth[*]

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1. It is now clear that **global output is shrinking. By definition this means that the real aggregate return on capital, labor and land, the factors of production, is shrinking as well. Compared to last year, there is less that can be distributed.** To make matters worse, price levels are on the retreat, at least in the developed part of the world economy. The fight for a larger share in overall income will therefore intensify - it can no longer be disguised or attenuated by money illusion. Real incomes are down, and so are nominal incomes. The winners are those who receive fixed income streams from solvent states, such as pensioners and holders of government bonds, or shareholders of price-setting companies which are able to maintain their dividends. For the larger rest, the loss in income will thus exceed the decline in real GDP.

2. **In the fourth quarter of 2008, real GDP shrank in all major economies**, at the following seasonally adjusted annualized rates (saar): US 6.2%, euro area 5.7%, Japan 12.7%, UK 5.9%. Using the weights published last October by the IMF in its World Economic Outlook and assuming that the other rich countries (which account for 16% of the advanced economies' total) saw their output fall at a rate of 5% yields an overall decline of no less than 6.4%. This group of countries accounts for 56.3% of global GDP (see page 253). On the basis of relatively up-to-date industrial production statistics it is also possible to calculate an approximate fourth quarter GDP growth rate for emerging and developing economies: it seems these contracted as well, perhaps at an annualized rate of 2%. Overall, therefore, **global GDP declined by 4½% in Q4**. I cannot remember anything as bad as this.

3. Collapsing orders and production in industry, rising unemployment, plunging corporate earnings and gloomy business and consumer surveys suggest that the **world economy is still in a free fall.** Rate reductions by central banks, positive terms-of-trade effects in commodity-importing countries and fiscal stimulus packages have helped but have not yet turned things around. This is not surprising given the time lags involved and the initial timidity of policy responses to the crisis which, even though it began in the summer of 2007, started to spiral out of control only half a year ago.

4. **Policy makers have long been in a state of denial, especially those who had thought that solid public finances, low inflation and current account surpluses would insulate their countries from international shocks.** The euro area, Japan, Sweden, and the Asian tiger countries were in this group. Most of the emerging economies also felt pretty safe because they had accumulated huge foreign reserves over the past decade. As it turned out, this has been wishful thinking. They were all seriously affected by the fall-out from

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[*] 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.

bursting housing and financial bubbles in countries such as the US, the UK, Spain, or Ireland.

5. Many suddenly realized that their own asset prices had reached unsustainable levels as well, and that a large chunk of their banks' capital exports had been invested in overpriced foreign assets such as American structured products and loans to borrowers in Central and Eastern Europe. **A favorable economic environment does not necessarily protect a country against exposure to asset price bubbles** - just the opposite, as Japan's history has shown. In this crisis, everybody sits in the same boat, sinners and do-gooders alike, and the boat is sinking fast. Globalization has its price. There is no splendid isolation for anybody.

6. It is more or less certain that **in the present quarter global GDP will decline at a similar rate as in the fourth quarter of 2008.** For the year 2009 as a whole the IMF has predicted, on the basis of purchasing power exchange rates, a growth rate of 0.5% y/y, and a decline of 0.6% y/y if market exchange rates are used. This forecast is a little over one month old. Looking at the data flow, I am fairly certain that the next one will be even lower.

7. What began as an American financial crisis has by now become a global recession. Saving the financial sector remains a key concern, but fighting unemployment will become just as important. In the **United States**, for instance, payrolls have declined by an average of 494,000 per month between last August and January, or 4.3% saar. If this continues – and there is no evidence that it won't – **the unemployment rate will pass 10% before the year is over.**

8. The **euro area** labor markets had looked much healthier until fairly recently, and policy makers tended to congratulate themselves for the absence of major imbalances. In the meantime, employment is shrinking as well, if only at an annualized rate of 1.2% so far (Q3 to January). But things are getting worse fast. Exports, capital spending and industrial production are all breaking away, and many **Central and Eastern European economies** which had become fast growing destinations for merchandise exports and capital flows are about to blow up and take western banks with them. Costly rescue operations are needed. Once-high-flying **Britain and solid Sweden**, two key trading partners of the euro area, are also in deep trouble and are forced to reduce their import demand.

9. **The problem is the absence of countervailing forces**. America's consumers, until recently the world's consumers of last resort can not quickly and smoothly be replaced by others. While still doing relatively well, **China** has been hit by the sudden fall of exports and the bursting of its home-made housing bubble. The country is too weak and too small to replace the US as the global growth engine. To put the potential role of China into perspective: its total merchandise imports are just 1.6% of America's consumption expenditures, and 7.6% of America's goods imports!

10. **Japan** has suffered from weak consumer demand, and domestic demand in general, for almost two decades and is unable to find a compensation for collapsing exports (down 35% y/y in the three months to January!); in east and south east Asia as a whole, industrial production is falling at double-digit rates. **Russia, South Africa and OPEC** saw their export revenues from commodities dwindle faster than they ever expected and are now confronted with problems that resulted from the end of their own borrowing sprees and construction booms. They are also hit by real income shocks caused by the collapse of their terms of trade, ie the depreciation of their currencies and the decline of export prices.

11. That global inflation has ceased to be an issue is not much of a consolation. The worry is now that **the main economies of the OECD area are heading toward deflation** as headline consumer prices have begun to fall while price indices ex food and energy – the “core indices” - have stopped rising since the third quarter of last year. Central banks are reluctant to admit, but they will soon have to fight deflation, not inflation.

12. Other than the Fed, the Bank of Japan, the Bank of England and the Riksbank, the ECB is at least officially still in a state of denial. It has always emphasized that it only cared for headline inflation, just as normal consumers, which was still at 1.1% y/y in January. Core inflation was 1.6% y/y. But it is a fairly safe bet that **some time this summer the ECB will have to respond to zero or even negative inflation rates**. Since it tries to keep inflation and inflation expectations at just below 2%, monetary policies will remain expansionary; quantitative easing will become part of the tool kit once interest rates approach zero.

13. A key feature of this recession is the fact that the debt of an increasing number of banks, non-financial firms and households is too large relative to the reduced post-bubble value of their assets. In many cases, **borrowers are financially under water – they have negative equity.**

14. This means they must repair their balance sheets to become creditworthy again. In order to strengthen their equity base and balance sheet ratios they have to reduce their debt As house prices and stock prices continue to fall, though, more and more borrowers are forced to pursue such a strategy. It is called **deleveraging** and **has by now become a deadly global process. Distressed selling of assets drives down asset prices even further, triggering more emergency selling. The world is still in the middle of such a process. It is extremely dangerous.**

15. From an economic point of view, the reduction of debt is the same as an increase of savings or a cut-back on spending. Other than in a garden variety kind of recession, **a so-called balance sheet recession, where debt reduction has top priority, can not easily be overcome by the usual mix of lower interest rates and expansionary fiscal policies.** Tax cuts, especially those that benefit the rich, tend to seep away in the form of savings and are therefore less effective than government spending. But it is also clear that the structure of government demand is quite different from private sector demand and can not fill the output gap one for one: households do not buy aircraft carriers, and the state is not in the market for toys or package tours.

16. **Neither central banks nor governments can do much against a balance sheet recession such as the present one. To have any noticeable effects, fiscal policies in particular must be extremely, some would say irresponsibly expansionary for a long time.** The US administration is doing just that: the budget deficit will exceed 12% of GDP this year, and if this does not help, larger deficits can be expected. China has also given up all restraints, as far as I can tell, while policy makers in the euro area and in Japan remain comparably timid.

17. To be realistic, one has to **wait until debt levels have shrunk sufficiently relative to the value of the assets held against them.** This can take a long time, as we have seen in the Great Depression or during Japan’s “lost decade”. To shorten the recovery process, part of

the debt has to be forgiven, and policy makers must probably step in some way or another where asset prices have fallen far below their "fundamental" values.

18. The former is obviously **unfair to creditors, savers and taxpayer**s – they get punished for their frugality, hard work and the trust in what their bankers had told them – but it is also inevitable.

19. The latter assumes that savers and financial institutions do not have the guts or the means to buy those bombed-out assets. But a massive intervention of the monetary authorities in the markets for equities, corporate bonds, various toxic assets and even real estate can be crucial to re-establish trust in the functioning of markets. It has worked in **Hong Kong in 1998**; not only that, it has also been profitable from a taxpayer's point of view.

20. One aspect has not been discussed much: that **the global recession can be much deeper than usual because the share of discretionary spending in total spending has become so large**. If need be, the average consumer can get by with rather little money and increase his or her savings substantially. Just one example: in many of the richer countries, basically every holder of a driver's license owns a car – and most of these have four seats. So even if car purchases came to a total halt, it will take several years before real hardship sets in. In general, it is thus fairly easy and painless to postpone purchases. So, if debt reduction in response to a collapse of asset prices gets top priority, an automatic recovery of overall demand may only occur at a very depressed level, once discretionary spending has been reduced to a bare minimum and replacement purchases kick in. This can be years away (or more than a decade - as in Japan?).

21. **For investors, the question is whether the above scenario of a deep and long global recession, low inflation if not outright deflation, large government budget deficits, and very expansionary monetary policies is already the consensus view or not.**

22. **Let's first assume it is not** – then the conclusion to draw is to buy a) long-term bonds issued by governments with an excellent rating or b) by governments such as Greece, Italy or Ireland that are likely to be bailed out, c) stocks and bonds of companies with a clear competitive advantage such as boring utilities, telecoms, food producers, pharmaceuticals with steady dividend policies, strong cash flows and conservative accounting. Property does not make much sense, nor do commodities, nor inflation-linked bonds.

23. **If my scenario is more or less already the consensus scenario, if things can not get worse than described, then all those gloomy predictions are already priced in by market participants. For the contrarian this means that the world is full of opportunities**. He or she can pick up assets at very low prices and thus with a huge upside potential: a) stocks and short-duration bonds of banks and insurers which are likely to survive are particularly cheap, just as those of car manufacturers, and cyclical stocks in general, b) euro and dollar-denominated bonds issued by reserve-rich emerging economy governments, preferably with a duration of less than three years, c) commodity stocks, especially of well-managed companies in countries whose currencies have depreciated a lot – oil, gas, coal, metals, including gold, d) real estate.

24. I believe that **we are near the point of maximum pessimism** which means it does not hurt to start investing again in assets that are totally out of fashion. On the other hand (I hate economists who use that term!) I am fairly sure that the news on the macro economy as well

as corporate earnings will get much worse before they get better, and that inflation rates will become negative and stay close to zero for an extended time, perhaps for two years. There is no need to rush or to fire all bullets that are in the magazine.

25. How about **currencies**? For quite a while now markets are playing the theme that the **euro area will break up**. The dollar is also supported by the improvement of the US balance on current account, the lack of coordinated and meaningful fiscal policies in the euro area, and the on-going reduction of the interest rate advantage of the euro. Here I would argue that all this has been priced in by now – but that the euro will survive. Just imagine the increase of real bond yields and real government and private sector debt if a country such as Italy or Greece decided to re-introduce its old currency. Deep structural adjustments and negative double-digit a real GDP growth rate are a much smaller evil compared to such a horror scenario. And the traditional paymasters of the euro area have already indicated that they stand ready to bail out the problem countries. The euro is cheap at this point.

26. **I do not really understand what is happening to the yen.** In a world of general deflation, low JGB yields are a disadvantage. Why not bet on higher-yielding Bunds, French OATs, Italian BTPs or Swedish kronor government bonds instead, even US Treasurys, where substantial capital gains can be expected as inflation expectations come down? As long as this looks plausible, the yen will depreciate (which is actually what Japan needs!).

27. I further think that the **depreciation of Eastern European currencies has largely run its course**. Since euro area banks are so heavily exposed to this region, there is now a strong incentive to keep these countries afloat. Debt re-schedulings are coming. Whether this also applies to countries outside the European Union such as Ukraine and Turkey is less than certain. As to the rouble, I would assume that its huge depreciation over the past half year has eliminated most of the previous overvaluation, and it has been stable for one month now. If commodity prices fall some more – which I expect – it is likely that the rouble will come under pressure again.

28. Finally, how about a **spread trade "long Bunds / short Treasurys"**? Bunds benefit from falling costs of carry as the ECB cuts the refinancing rate from its present 2% level, the coming rebound of the euro exchange will strongly push down euro area inflation rates, German government budget deficits will be much smaller than America's for years to come, and yields are still 11 basis points higher than those on Treasurys (in the 10-year range).

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