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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

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1. For the first time since the forties, the **world's output is shrinking**. The consensus forecast for 2009 calls for a year-over-year decline of almost 3% if national GDPs are weighted with current exchange rates rather than purchasing power parities (PPP). The IMF has just published its new World Economic Outlook where it predicts world output will be down 1.3% y/y on a PPP-basis (which gives a larger weight to faster growing emerging markets; p. 10). World trade will decrease by an unprecedented 11% year-over-year. In advanced economies, consumer price levels will fall by 0.2% y/y.

2. **This implies, on a global scale, steeply rising unemployment, weak corporate earnings and stock markets, falling commodity prices, deflation rather than inflation, and a flight to safe cash flows. Fiscal and monetary policies will be very expansionary for the foreseeable future – economic activity is slowing so quickly and on such a broad scale that these policies can at best slow the process. There are no indications yet of a turn-around.**

3. Growth predictions for 2009 have been revised down by no less than five percentage points within just one year, including the IMF's, an indication that **standard macro models are of very little use.** They fail to take into account that the world economy is not only being dragged down by the usual cyclical forces that come into play after a long expansion but also by the effects of burst asset prices and credit bubbles on spending plans and balance sheets. The spillover effects between countries, transmitted through trade and capital flows, are not well known and apparently impossible to model. Massive negative wealth effects combined with the need to reduce the considerable leverage that had been used in the financial sector, in other previously booming industries such as construction or transportation, but also by private households, now require the restoration of balance sheets. **The reduction of debt has become a top priority. This is neither a project for the short-term nor does it lend itself to easy fixes.**

4. Yet, **looking at stock markets, a broad economic recovery could be close at hand**. From recent lows in February or early March, the S&P 500 has rebounded by 25%, the Nikkei 225 by 23%, the DAX by 27%, Russia's RTSI$ by 61%, and the Shanghai Composite by 42% (since end-October). The same message from commodity markets: the benchmark West Texas Intermediate oil price has gained 61% since the end of last year. Rising yields of government bonds also suggest that market participants are betting on an end of the deflation play. Remarkably, just as markets had gone down in lockstep they now move up in a very synchronized way.

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5. But are markets right, and should even cautious investors finally give up their reluctance and join the party? I recall **Paul Samuelson**'s remark that stock markets have correctly anticipated 15 of the past eight economic recoveries – or something like this.

6. There are two ready explanations why investors are buying equities and commodities again: **a) Prices were extremely low at the outset of the present rally** – the S&P 500 had come down 56% from its recent high, the Nikkei 51%, the DAX 55%, the RTSI$ 80%, Shanghai 71%, and oil 78%. In other words, there seemed to be lots of attractive opportunities; investors thought – and think - they couldn't do much wrong by cautiously returning to the market. **b) After the extended bear market** that had correctly reflected poor fundamentals, ie the deepening recession, there were more **short positions than usual; these had to be squared** in order to lock in profits, and the best time to do this was when the news began to be less bleak. Lately, American and European data on business and consumer sentiment have indeed improved. As a result of the long investor strike there was also plenty of cash looking for a home.

7. The two explanations are sufficient to support a market rebound. Since early August 2007 when the crisis began, stock markets had staged five or six similar recoveries. To me, **we have just seen another bear market rally**. When markets have reached depressed levels, huge percentage gains are normal. Take the Russian stock index: after its 80% fall it must rise 400% just to get back where it was before (in May 2008).

8. The global recession is very deep, and it is therefore likely that **corporate earnings** will remain under pressure. These are much more volatile than labor costs: they rise faster in a boom, and they fall a lot more in a downturn.

9. **In the US, profits have now declined six quarters in a row**. The **main reason is weak private consumption**. At $9.93tr annualized it was still 69.9% of nominal GDP in Q4 and therefore the key component of demand. For many years, the demand of American households had been the main engine of global growth. This is no longer the case. Consumers are in a state of shock and are cutting back on expenditures – since June 2008 these have been shrinking (in volume terms), with very negative consequences for the rest of the world..

10. **One reason is the rapid deterioration of the US labor market**: unemployment has shot up from 4.4% two years ago to 8.5% in March, and non-farm payroll employment has shrunk at an annualized rate of 5.8% between last August and March. Weekly initial jobless claims suggest that the situation has deteriorated further in April. It is difficult to find a job.

11. **Incidentally, the euro area is so far doing much better in this respect**: the unemployment rate has increased from a low of 7.2% in March 2008 to just 8.5% in February, employment has declined at an annualized rate of only 0.9% between Q2 and Q4 last year, or, more up-to-date, by 0.9% in Germany (between October's peak and February). Continental Europe's sticky labor markets and its mostly consensual approach in labor relations are stabilizing factors in downturns.

12. **Another factor that shocks American consumers is house prices** – they keep falling in spite of their 29.1% decline from the July 2006 peak (S&P/Case-Shiller Composite-20 Home Price Index). Housing starts are still running well ahead of new home sales, which means that inventories of unsold homes remain near record highs (of about one year's

supply). Another price decline in the order of 20% would thus not be a surprise. It pays to postpone the purchase of a new home, and it does not matter much that mortgage rates and house prices have fallen significantly. Such are the nasty consequences of deflation.

13. Borrowing on the basis of rising house prices had given a strong boost to US consumption, now falling prices are forcing households to reduce debt and spend less. In this respect, the structure of the recession resembles more and more that of Japan in the nineties. **Overall, ie including financial assets, the net worth of US households has declined by $13tr since Q2 2007, close to one year's GDP**. As a result of all this, the household savings rate which had hovered in the neighborhood of zero for much of the previous economic boom is now expected to reach 7% by the end of the year.

14. **America also suffers from a banking crisis**, comparable to the earlier one in Japan, and policy makers do not really know what to do about it. In its new Financial Stability Report the IMF estimates that potential cumulative writedowns for 2007 to 2010 on the financial sector's loans and securities will be $2.7tr, or 10.2% of the total outstanding (p. 28). Roubini thinks it will be even more – because the IMF's economic forecast for the US may be too rosy. The ongoing recession impairs the quality of an ever wider range of financial assets. In any case, these are huge numbers, and it is possible that the tier one capital shortfall will be in the order of $1tr. Where will the funds that are needed for the recapitalization of the financial sector come from? Congress is not amused about the prospect of shelling out another 7% of annual GDP to save the unpopular bankers, and will certainly put up a fight. The upcoming stress tests of the sector will probably take into account the adverse political climate and avoid an overly negative message.

15. **Sluggish US consumer demand has been the main reason for the dramatic improvement of the country's balance of trade**. Since their peak last summer, merchandise imports - which are mostly a function of household spending - have collapsed by no less than 46% in nominal, and 29% in real terms. Import prices are falling rapidly, but the volume of imports is dramatically down as well. The US is no longer the world's importer of last resort.

16. How about **US exports? These are also very weak**: -32% since last July in nominal, -24% in real terms. They struggle because the rest of the world is also in recession, and the dollar had been fairly strong recently. For the time being, ie **in the fourth and the first quarters, net exports have provided a strong boost to an otherwise stumbling economy**, but I doubt that the US will now turn into a surplus country and become a net capital exporter - even though this would make economic sense for one of the richest countries on earth. Massive fiscal injections imply that the government will more than absorb the additional savings generated by scared private households – budget deficits will reach 10 to 13% of GDP this year and next. Net capital imports will therefore be needed.

17. **Deflation has arrived in America's headline consumer price index**: in March it was 0.4% below its year-ago level, and has declined at an annualized rate of 5.4% since last September. Ex food and energy, prices were still up 1.8% y/y in March, and +1.2% saar since September. This does not yet quite look like deflation. Wages have still been rising lately, if only at rates of 1½%, and medium-term inflation expectations are within the Fed's comfort zone of 1½% to 2%.

18. Once the effects of the commodity price decline drop out of the index, so the argument, headline inflation will be back in positive territory. I am not convinced: output gaps are very large and continue to grow which makes it difficult to raise output prices and wages. To avoid deflation, the US need, most of all, a much weaker dollar. For the time being, Asian central banks and oil exporting countries will try to prevent this. They want to maintain their price competitiveness and the value of their dollar currency reserves.

19. **Concern about deflation is also rising in the euro area**. In spite of the rather weak euro exchange rate consumer prices have gradually fallen since last June (-1.0% saar). Just as in the US, so-called core consumer prices have been rising at an annualized rate of 1.2% (since June).

20. **The ECB continues to dismiss deflation risks, but going by its deeds rather than its words, it must be quite scared of the prospect of falling price levels**. At the zero interest bound monetary policies become toothless: from that point on a falling price level means rising real central bank and money market rates. As deflation usually comes with declining economic activity, rising real interest rates are the opposite of what is needed for the revitalization of demand.

21. **Quantitative easing** will probably be the next move after the traditional tool kit has been emptied, as in the US and the UK, but since money printing is an untried strategy in advanced economies and provokes negative responses, especially in Germany, a success is not at all assured. In Japan, quantitative easing has been a failure. At the upcoming ECB board meeting in May, where the main refinancing rate will be cut by 25 basis points to 1%, we will learn more about how the ECB intends to move forward.

22. **The deflation risk is about as serious as in the US. On the one hand, output is falling more rapidly**, not least because of the weakening external sector. To some extent, the improvement of America's balance on current account corresponds to a deterioration in the euro area. Industrial production is in a free fall (-20.3% saar between Apr 08 and Feb 09), and it seems that real GDP has probably crashed by 2% q/q in Q1, or more than 8% annualized, which may have pushed it 4.1% below its year-ago level. For the year as a whole, the latest IMF forecast for the euro area is -4.2% y/y – this may be an optimistic forecast. America's GDP will only shrink by 2.8% this year, says the IMF. **On the other hand, the depreciation of the euro** against the dollar means that euro area import prices are declining not nearly as fast as in the US and have thus less of a deflationary impact. So, seen from the economic activity side of the picture, Europe's deflation risks are more serious, seen from an exchange rate angle, they are less serious.

23. The ECB must be glad that the euro has come down from last year's high of almost $1.60 and hope that it does not start to appreciate in earnest again. Will Asian central banks hold on to their dollar reserves in spite of double-digit US government deficits? **Even without a stronger euro, the ECB's task of reaching the self-imposed inflation target of somewhat less than 2% is almost impossible to achieve in the foreseeable future.**

24. **For financial investors, euro area government bonds, or guaranteed bank and other corporate bonds are rather attractive if I am correct about my inflation outlook.** In the 10-year range, nominal government bond yields are 5.31% in Greece, 4.29% in Italy, 3.58% in France, and 3.21% in Germany. No, the euro will not blow up – for the potential leavers, the alternatives are too horrible. Even now, for all their problems, including high

real long-term yields, they are much better positioned than they could ever expect if they were slugging it out on their own. Keep in mind that money market rates are the same across the euro region, which means that troubled Greek, Irish or Portuguese borrowers can at least partially reduce their funding costs by switching to the short end of the yield curve.

25. **Why not channel some funds into supposedly riskier Club Med euro-denominated bonds?** The inflation rate is the same for everyone in the euro area – it is just 0.6% y/y and falling. Wait for the ECB to start buying these assets, as it must. They are also attractive for institutional investors who have promised yields to their clients or members well in excess of Germany's bond yield of 3.2%, and of course for banks which can earn a spread of 300 or 400 basis points over their short-term funding costs.

26. **Investments in euro area equities do not make much sense at** this stage, except perhaps stocks of solid market leaders with attractive dividend yields. In general, and contrary to market consensus (as reflected on Bloomberg's p/e pages), per share earnings are falling. It can not be any other way as output crashes while cost reductions can only be achieved gradually. Firms have almost no pricing power (the weak euro helps a little, but for how long?), international competition is fierce, and everybody tries to reduce idle capacities by offering products at prices close to marginal costs.

27. As it is, **European price-to-earnings ratios are calculated on the basis of banks' and brokers' exaggerated profit expectations.** In reality, the main continental indices should be valued in the region of 20 (2009 earnings) rather than 10. Moreover, in a genuine recession, p/e ratios should be in the single digits. Still some way to go. Except for some business surveys, leading indicators do not hold out much hope that an economic recovery is around the corner: profits remain under pressure.

28. **The main problem of this recession is that it has engulfed the whole world**. There is no one to help – which is different from Japan's relatively benign post-bubble situation in the nineties. This calls for a coordinated international approach à la G20. In the area of monetary policy this is de facto already the case, because all central banks try to stimulate demand by pursuing expansionary strategies, but fiscal policies are very diverse because there is no agreement about acceptable government deficits. In continental Europe in particular, the sense of crisis is only gradually increasing: since labor market problems look manageable so far, a go-slow approach is preferred, while Anglo-Saxon policy makers have pulled out all stops, as have the Japanese and the Chinese.

29. **Japan's economic activity has almost come to a halt,** it seems. Since last May, industrial production is in a free fall and is now 38% less than one year ago. Real GDP is estimated to have fallen at an annualized rate of 15% in Q1 (Germany's has probably been down by "only" 11.5%). Full-year forecasts are in the order of -7% y/y. Utilization rates are at record lows, and firms will probably attempt to reduce productive capacity – which exacerbates the crisis. Machinery orders crashed seasonally adjusted 22.9% m/m in February, to their lowest level ever, exports are down about 50% from last year, and there is now, for the first time in decades, a trade deficit. Deflation is back, including in real estate.

30. **All this is rather puzzling, given that the yen's appreciation has by no means been excessive, especially in real terms**, and that Japan is part of the world's most dynamic and, population-wise, largest region, with a huge catching-up potential for which it has the right products on offer. It is, of course, an indication that spending on capital goods and

sophisticated consumer products is very volatile. In a crisis, the first thing firms do is to stop their expansion plans – which means they cancel orders for capital goods – while households will economize on discretionary items such as play consoles, flat screen TV sets, or even cars. Japan's troubles may also be a sign that China and the rest of emerging Asia have bigger problems than reflected in official statistics.

31. **China – more so than India – is the star performer these days**. In Q1 real GDP has rebounded at an annualized quarterly rate of about 6% and is thus seemingly little affected by the slump of exports to the US. Policy makers have swiftly and successfully shifted gears, it seems, with the aim of boosting domestic demand (and reduce the extremely high savings rate): they announced a comprehensive medical insurance plan for the rural population, to be fully implemented by 2011; in November, the government launched a massive fiscal stimulus program focused on infrastructure, and is prepared to do more to boost household spending via tax cuts and direct subsidies for consumer appliances. Monetary policies, meanwhile, have become very expansionary after deflation has returned.

32. **In view of China's high savings rate and more than sufficient currency reserves, these policy shifts are anything but reckless.** But keep in mind that China's goods imports were only about $1tr in the past twelve months - and declining quickly -, almost exactly half as much as America's. Moreover, the balance of trade surplus is still increasing and I guess that China's net effect on the growth rate of the rest of the world is therefore negative, just as America's now. Most forecasts call for an increase of real GDP of about 7% for the year as a whole, an impressive rate in an international context. **Stock markets are fundamentally well supported.** Industrial policies and capital controls are obviously the right recipes for a country like China.

33. **Russia** which has more wholeheartedly adopted liberal trade ideas and free markets, is a study in contrasts: the **IMF expects its real GDP to shrink by 6% y/y** for the whole of 2009, unemployment is skyrocketing, and the trade surplus is only about one third as high as a year ago. On balance, though, Russia is still a net exporter of capital, a somewhat unlikely feature for such a poor country – the environment for long-term capital investment is still not good enough, not even in the eyes of the Russians themselves it seems.

34. **The country is exposed to a terms of trade shock**: import prices have been rising – partly due to the large depreciation of the rouble - while export prices have collapsed. This has resulted in a decline of domestic purchasing power and falling real wages. International competitiveness may have improved but domestic demand is extremely weak.

35. **So what is the outlook for Russia?** It is premature to bet on a recovery of commodity prices, which are still crucially important for its economy, as long as the world is in recession. The corporate sector is highly leveraged and struggles to reduce its debt by cutting costs, reflected, as mentioned, in rising unemployment and falling real wages. Even so, non-performing loans at banks are steeply up and seem to be heading toward 20% of all loans outstanding. Banks have thus become increasingly risk averse and seem to need some strong arm-twisting by the administration before they hand out new loans. Negative real short-term interest rates are the right medicine in this situation, but are not enough to revitalize the intermediation process.

36. **The massive improvement of the Russian stock market is somewhat surprising given these poor fundamentals**. The best explanation lies in the fact that average current-year

price-to-earnings ratios had at some point fallen to less than 3. This is extremely low given that the country is by no means a basket case and financially much more robust than Ukraine, Hungary, Romania or the Baltics, to mention just a few. Furthermore, everybody seems to have gone short once it had become clear that commodity prices were in for a large downward adjustment last summer – profit taking on these positions has been a driver of the stock market rebound.

37. **Russian equities are still very cheap, not only in p/e terms but also in terms of price to book ratios. Especially the electricity sector where administrative prices are set to rise looks rather undervalued on both metrics. The main risk is that commodity prices will resume their downward trend after the present calm. The global recession is still with us, after all.**

38. **When will the world economy take off again?** All this gloom is not good for my and your health, and may become self-enforcing. Why should so much of the world's productive capacity lay idle when, at the same time, there is so much poverty and so much that can usefully be done even in rich countries?

39. Some **business surveys** are rebounding, especially in the euro area. These are the now-famous green shoots. Anything else? Monetary policies have driven **real interest rates** to levels where borrowing starts to make sense again – were it not for the unfinished business of deleveraging. In some countries and sectors production is shrinking faster than incoming orders – **inventories** will become less of a drag on growth. In the euro area, the opposite is still happening. Further: at some point **savings rates will be sufficiently high**, creditworthiness will have been restored while daddy's old jalopy, the family furniture and youngster's play console look embarrassingly out of date. Are we at this point? Not quite yet, it seems to me.

40. One thing is certain: as unpopular as it is, governments have no choice but to **cut taxes** and to **increase spending** if they want to fill at least part of the gap left by weak private sector demand. It is unlikely that bond markets will punish them for this, at least not those of financially sound countries. Japan provides the role model in this respect. That considerably more expansionary fiscal policies are generally not considered to be acceptable strategies may be the largest obstacle that stands in the way of a near-term recovery of the global economy.