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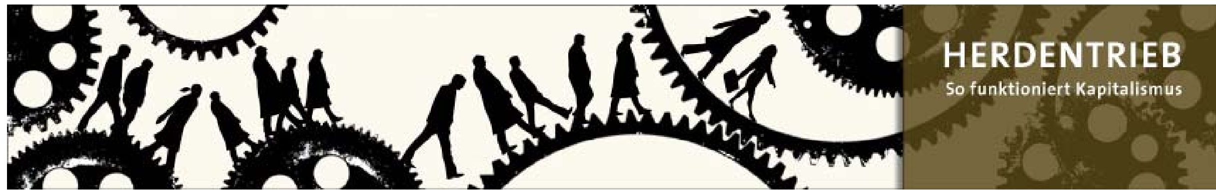


# Wermuth's

# Investment Outlook

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# Wermuth's Investment Outlook

**by Dieter Wermuth***

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1. **Stock markets are booming once again.** The S&P 500, the Nikkei and the DAX, the equity indices of the three main advanced economies, have gained between 37% and 38% since their lows in early March this year while the stock markets of the four BRICs have done even better: Brazil +78%, Russia +123%, India 84% and China 52%. **The hard data to support such rallies are still lacking.**

2. The main driver has been the impression among market participants that **things could not get worse** anymore; in Q4 and Q1 global real GDP contracted at unheard-of annualized rates of 7.1% and 7.5% (using current exchange rate-weights). Moreover, all recessions will end one day. Combined with improving, though still rather depressed, results of household and business surveys and the recent stabilization of retail sales, industrial production and order books, this has brought back optimism. **Investors know that the best entry point is when things are terrible but appear to stabilize. This is how things look to them today.**

3. Even so, stock markets have got ahead of themselves. Take the S&P 500: on estimated 2009 earnings, the price-to-earnings ratio is no less than 16, above the historical average, and the price/book ratio is a generous 2.0. The Nikkei trades at a p/e ratio of 44 (!), and the p/b ratio stands at 1.3; the comparable numbers for the DAX are 14, and 1.35. **In a deep recession p/e ratios typically drop to single digits, but in this cycle markets have never been there – in recent months valuations have actually increased.**

4. **Emerging stock markets** had collapsed from their all-time highs reached in the early summer of 2008, and had a correspondingly large upside potential. They fall more and they gain more than markets in richer countries, just as the prices of their main export products which are either commodities or commodity-like manufactured goods. In spite of their impressive rebounds, Russian and Chinese stock indices are still 55% and 50% below their previous peaks, Brazil's and India's around 28%. Brokers begin to upgrade earnings prospects in BRIC and other emerging markets.

5. **The present strength of this region is owed to arguments similar to those that have driven developed countries' markets**: stimulating policies, an imminent end of the recession, an improved outlook for exports, plus a pick-up of demand for commodities. Except perhaps for Russia, with a p/e ratio of 10.0, emerging markets are not really cheap though. China's and India's p/e ratios are close to 21, Brazil's is at a more reasonable 13.4. Stock indices are low relative to their highs of last year, but not cheap based on current profits. It takes a very strong recovery of these to justify the rather rich valuations.

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6. **A new twist provides additional support for raw materials and equities**: as countries such as the US, the UK, Japan and perhaps even the euro area are trying to reduce their ballooning debt – which gets heavier and thus harder to service when price levels are declining, ie in a deflation – **by debauching their currencies, real assets provide an inflation hedge.** This stimulates the demand for them and drives up their prices (real estate does not qualify yet, due to its oversupply in several key countries).

7. Swamping financial markets with liquidity and bailing out banks and non-banks alike in a big way may already have the desired effect. **To increase inflation expectations has been the stated aim of policy makers** who began to run scared when they realized that deflation had arrived in the US, in Japan, in China and in Germany. The euro area as a whole is close to deflation as well.

8. **Government bond markets are rather weak, as one should expect, given the prevailing mood of investors**. They argue that, if the cyclical turning point of the global economy has indeed been reached or is close at hand, inflation is bound to increase. Also: when this happens, risk aversion will decline – it had previously been very high, as the recession had deepened, and had thus been one of the drivers of the earlier bond market rally. Now bonds are no longer needed as safe havens. Moreover, the fact that government deficits will remain huge as far as the eye can see is gradually taking hold of investors' minds – what will happen to those mountains of debt in the long run?

9. **Relative to actual inflation, government bonds are unusually attractive**. 10-year US Treasuries, for instance, yield 3.66%, or 161 basis points more than at the end of 2008 (2.05%) when yields hit bottom. Year-on-year consumer price inflation is -0.7% which makes for a real yield, on this basis, of 4.36%. This is way above the "natural rate", however defined. Medium-term productivity growth, one possible benchmark, is at best 2% per annum. The situation in the euro area is similar, but less extreme: 10-year Bunds yield 3.64%, consumer prices are 0% y/y, real yield therefore 3.64%, and productivity growth perhaps 1 ½% per annum; the low point of Bund yields had been 2.89% last January.

10. In other words, **market participants are bidding farewell to deflation and put their money on a return of inflation.** At $977 gold is approaching its previous high, oil has more than doubled since its December low (WTI is now $68). The demand for inflation-linkers, government bonds that provide inflation protection, has increased recently.

11. **So here we are at the crucial point: what will be the time path of US, euro area, Japanese, Chinese and global inflation? Is it really a foregone conclusion that the coming economic recovery will soon put an end to falling price levels in key countries?**

12. **Never before have monetary and fiscal policies been more expansionary than today.** Policy makers claim they have learned the lessons of the Great Depression and of Japan's lost decade(s) and try to be anything but timid and slow in their responses. Investors presently want to believe that the medicine will work. Confidence that the worst is over – must be over - has steadily been rising this year which has in turn set in motion a positive feedback loop. **Green shoots everywhere**. (You know the one about the Panda bear? He eats, shoots, and leaves. Take away the commas and you see what will probably happen to those shoots.).

13. For me, it looks very much like wishful thinking. **Where are the hard facts that support the dominant market view** that this will be a V-shaped recovery? I agree that the decline has been so extraordinary that it can not go on like this – any sort of normalization can lead to very positive month-over-month changes in output. But beyond that?

14. What sets this crisis apart from previous ones is that **we are dealing with a global mess**. The main risk is that many institutions lack the capital to survive, given the deterioration of their assets, but may not know it. Because there is so much slack in the world economy, firms are forced to cut output prices, postpone or give up capital spending and lay off workers while wage inflation comes down steeply.

15. Producer price inflation, ie pipeline inflation, is now -3.7% y/y in the US, -3.8% in Japan, -6.6% in China and -2.7% Germany. Export price inflation is also negative in these countries. **Price wars will remain intense for at least another year**. Inflation expectations may have risen but it is likely that they will come down again as actual inflation numbers point relentlessly in the other direction.

16. What we experience is a **hangover after a long party that was fueled by easy credit**. Bust followed boom, because, as Herbert Stein, the former chairman of the US Council of Economic Adviser, famously used to say "what cannot go on forever, won't". Bubbles always burst, by definition.

17. The problem is, before the global economy has a chance to get sober again, **ie before the major imbalances has been corrected, the same old medicine is being applied once more, but in much larger doses.** The main central banks have cut interest rates to close to zero and must now print money, called quantitative easing, to re-launch the stalled lending (and growth) process.

18. **Recessions are not allowed to happen, ever, which is rather problematic** because market forces are prevented from bringing about a new structure of production that matches changes in demand. Recessions are not all negative. Rescuing Opel or General Motors or department store chains whose departure no one would regret except the people who work there are symptoms of what I have in mind.

19. **Monetary policies are not yet effective, as aggressive as they may be. It is like pushing on a string. Lenders are risk-averse and undercapitalized, and the potential borrowers are too indebted or operating too far below potential to respond to the incentives.**

20. Everywhere **households are faced with dramatic job losses** and – especially in the English-speaking world – **with declining real estate wealth** which pushes more and more of them financially under water. In addition, things will get cheaper over time in a deflation, so what would be the rationale of spending and borrowing now? In the US, the household savings rate will have climbed from around zero not long ago to about 7% before this year is over. **American consumers** have become a drag on global demand and are no longer the world's spenders of last resort. The US presently relies on foreign trade to get its economy going (apart from government spending), in a reversal of its previous role.

21. **European consumers have tightened their belts as well even though they are much less indebted** and in spite of the fact that labor markets have not deteriorated nearly as much as in the US. Employment has been down at an annualized rate of 0.9% between Q2 and Q4 (the most recent available data), and the unemployment rate stood at 9.2% in April, after 7.3% one year ago. America's employment has declined by no less than 3.6% y/y in April while the unemployment rate has skyrocketed from 5.0% in April 2008 to 8.9% (and probably to 9.2% in May).

22. These numbers reflect the relative **rigidity of Europe's labor markets, a welcome but usually underappreciated stabilizing factor in recessions.** Note that real euro area GDP will, according to the IMF, fall by no less than 4.2% y/y in 2009 while America's will be down by "only" 2.8%. Euro area employment would be lower by about 5% y/y, or 7.4 million workers, at this point if labor markets were as flexible as those of the US.

23. As resilient as euro area labor markets are, they will still get much worse, and consumers are aware of this. This is why real household consumption has declined at an annualized rate of 1.8% between Q3 and Q1 and thus by somewhat more than America's (-1.4%) over the same period. To sum up, it is **highly unlikely that the consumers of the world's two largest economies will launch a spending spree and rekindle inflation anytime soon.**

24. How about **business investment**? On a purchasing power basis, the trend rate of global GDP has been 3.5% per year during the past two decades. I estimate that the world economy is presently operating 5% below the level of 2007. Rather than declining, **slack will increase in coming quarters** because a return to trend growth of 3 ½% is extremely unlikely. Airlines and shipping companies, for instance, report huge and rising idle capacities. World trade is still shrinking. Industrial output may not fall much more but it is presently between 15 and 20% below last year's levels.

25. **Why should business even think about raising capital outlays? The main concern is to cut costs**, and the best way to achieve this is to increase the rate of capacity utilization via reducing output prices to marginal costs, aside from laying off workers and shedding (the least efficient parts of) capacity. **All of this has clearly deflationary effects**. Interest rates play a fairly minor role in adjustment strategies. Moreover, short-term rates cannot fall much more, and long rates have been on the rise, especially in real terms (quantitative easing may actually be responsible for this).

26. **The most dynamic component of global demand is government spending**. Since resistance against running large budget deficits is quite weak by now, given the depth of the recession, policy makers are in a position to fill part, or all, of the gap between potential output and demand. As it is, they are even more ambitious.

27. Here are the **IMF's estimates for the so-called structural budget deficits in 2009**, ie those components of the deficit which are not accounted for by automatic stabilizers - the cyclical effects of lower state revenues and higher spending on unemployment benefits and so on: advanced economies as a whole 4.6% of GDP, US 6.0%, euro area 3.0% (Germany 2.0, France 3.3, Italy 2.7, Spain 5.2), Japan 6.5%, UK 6.7% (page 11 in the Statistical Appendix of the April World Economic Outlook).

28. **Contrary to perceptions, the BRIC countries, with the exception of Russia, do not pursue comparably expansionary policies**. While there are no data on structural deficits, swings in the overall fiscal balances of central governments (page 13) are hardly larger than the rates of decline in capacity utilization. China will therefore hardly be the world's new engine of growth (provided the IMF numbers are close to reality).

29. **On balance, fiscal policies are so expansionary that they will fill most of the output gap that has opened since 2007.** But the gap will widen again, not shrink, if the IMF is right about next year's global GDP growth rate of only 1.9% (0.0% in the advanced economies).

30. **In Japan, from the nineties to today, structural balances have consistently been much larger than the output gap** (in percent of GDP, page 203 of the IMF's main text), **yet inflation simply refused to re-appear.** Between 1991 and 2008 its annual average has been just 0.2%. One reason for this extraordinary price stability in the face hugely expansionary fiscal policies is probably that the structure of public sector demand was, and is, very different from the structure of consumers' shopping baskets. Consumers do not buy roads nor do they hire teachers or policemen.

31. **So much for the risk that large government deficits will inevitably lead to an acceleration of inflation.** 10-year yields of Japanese government bonds are still only 1.5% - looking at this number alone would anybody guess that debt will be 217% of GDP this year (IMF, ibid, page 203)?

32. **The fear of inflation is overdone. Without a broad-based recovery of private demand inflation will remain subdued or negative**. And an economic recovery will not happen before the balance sheets of banks and other businesses - as well as those of households in countries where property bubbles have burst - have been sufficiently repaired. This is not yet evident. Not to forget, unemployment, as a lagging indicator, is still on the rise, while corporate profits remain under pressure. And even if there is a recovery, it does not mean that inflation must rise – in the initial stages productivity gains tend to be large (which lowers unit costs); firms also fight for market share by keeping their output prices under control.

33. **If I am right about the inflation outlook, if price levels will indeed stay low, then European and American government bonds are good buys. Perhaps it is still too early to enter because market makers are still in a state of denial about the risk of deflation. But it is only a matter of time**.

34. **Commodity prices** also suggest that market participants are impressed by those super-loose fiscal and monetary policies. They are convinced that these will work and that inflation will return. High commodity prices themselves could trigger inflation. They won't in the present environment! In Germany, monthly inflation rates have been on a slight downtrend since last December even though gasoline prices have increased from €1.03 a liter then to €1.35 this morning. **Industrial production is too weak globally to support the rally in commodities – their prices are bound to come down again.**

35. **Why is the euro so strong?** Brokers offer a surprising explanation: risk aversion is on retreat because of the coming expansion, and a risky asset such as the euro thus benefits. In times of crisis investors flock to the dollar, and since the crisis will soon be over, they look for alternatives.

36. The ECB must be irritated by this view. **Why should the euro be a risky asset relative to the dollar**, given the euro area's more conservative approach to fiscal policies and the monetization of government debt. Is there not an oversupply of dollars in central banks' portfolios, especially China's. The euro is much less exposed to selling because its share in international reserves is much smaller. While the US has impressively reduced its balance of trade deficit, it is still much larger than that of euroland. It cannot be denied that the characterization of the euro as a risky asset has played a role in recent months, but the more plausible **reason for its new-found strength lies in fundamental factors. These will continue to support it.**

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