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Wermuth's

Investment Outlook

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Wermuth's Investment Outlook

by Dieter Wermuth[*]

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1. Corporate earnings remain under pressure globally, as anybody will quickly notice who compares changes in unit labor costs and output prices. The former, a proxy for total costs, are up steeply, while the latter, a proxy for revenues, are either flat or down. **Stock markets are therefore not well supported.** It does not come as a surprise that investors are presently keen to lock in the gains achieved since the lows of last March. Puts on stock indices - the right to sell stocks in the future at a price fixed today - are as expensive as after the Lehman default last autumn.

2. **On average, stocks are not cheap. Price-to-earnings ratios are mostly still in double digits. In a recession as severe as the present one I would expect these ratios to drop to single digits at some point. This has yet to occur.**

3. On the **fixed income** side the main message is the same: the recession is by no means over, and deflation is a greater risk than inflation. Even though government budget deficits keep heading for the stratosphere yields of long bonds are on the way down. Reliable and steady, if modest, cash flows are extremely valuable in an uncertain environment.

4. Using actual rather than expected inflation rates to calculate real yields shows that **bonds are cheap and therefore in good demand.** In the US as well as in Germany, nominal 10-year bond yields have fallen by about 40 basis points from their early-June highs and may well reach less than 3% once again. Even Japanese government bonds which, at first glance, look very expensive have rallied and are now yielding 1.30%. But then, June consumer price inflation will probably be in the order of -1.5% y/y!

5. **Most commodities are expensive.** They had a good bear market rally between last December and the middle of June which reflected the expectation that the unprecedented monetary and fiscal stimulus would lead to an early and vigorous rebound of growth. Especially China’s robust performance had impressed commodity traders. They detected green shoots wherever they looked. The prices of oil, copper and tin rose to levels which were once again far above their historic trend lines. Oil had gained 130% at one point.

6. In the meantime, **market participants have become less optimistic about the economic outlook** and begin to realize that the present stabilization of world GDP will not be followed by an early return to previous output levels and growth rates. Output gaps will remain large, probably for years to come, which is not a favorable environment for commodities. In general, the **prices of raw materials are bound to retreat further – inventories are larger than usual.**

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7. In the following, I have **a closer look at unit labor costs. Readers may skip this section** (paragraphs 8 to 13) which is full of statistics – they prove the point that corporate profits are, and will remain, under severe pressure.

8. **In the US** manufacturing sector, for instance, unit labor costs were up 12.0% y/y in Q1. Producer prices, meanwhile, had fallen by 2.2% y/y. In other words, the key cost component is rising fast while output prices are deteriorating. **Earnings per unit of output must be collapsing.** No wonder that the pace of lay-offs in manufacturing is running at a high rate; in June, employment was down 12.2% from one year ago.

9. Outside of manufacturing, things look less bleak. For **US business as a whole**, unit labor costs had been up by only 2.0% y/y in Q1. But output prices are on the way down since last fall, and therefore profits of domestic industries continue to shrink. Since Q3 of 2006, they have declined at an average annual rate of 16.2%; in Q1 of this year, they were 21.9% lower than a year ago (according to the US Bureau of Economic Analysis). It could be that listed companies fare better than industry as a whole, but the difference is probably not be significant.

10. **In Germany, the situation is at least as bad.** For the economy as a whole, unit labor costs in the business sector had risen 10.3% y/y in Q1, mostly because of a steep drop of productivity (in the goods producing sector less construction unit labor costs were up by staggering 23.4%), while producer prices had declined by 0.7% y/y. This is a deadly combination.

11. So far, firms have mostly held on to their workers, partly because of government subsidies, partly because they hope that the recession nightmare would soon be over. Given that the volume of new orders has been -33.3% y/y in manufacturing and -11.8% y/y in the construction sector (April/May and March/April averages) there is little hope that the situation will improve. **As profits crash, large-scale lay-offs are a near-certainty.**

12. **In the euro area as a whole the situation is probably not much different.** We do not know exactly how bad it really is because aggregated statistics for the 16 member countries arrive very late: unit labor costs were +4.7% y/y in Q4, producer prices +3.3% y/y. There is no doubt that the former are about +10% y/y by now, while EU-16 producer price inflation has recently been running at -5.8% y/y (May). **Profits are in a free fall.**

13. **I guess that in Japan**, the world's third largest economy (behind the euro area), **corporate profits are also catastrophic**: employment was down "only" 2.1% y/y in May while industrial output was 27.5% lower than one year ago; this translates into a big decline of productivity. As to the economy as a whole, real GDP in Q2 has probably been down 8.2% y/y. Even if nominal wages are falling by now, it is clear that unit labor costs are on a steep uptrend. Looking at the revenue side, producer prices are down at a similar rate as in the euro area (-5.4% y/y in May). Japan is forced to slash export prices (-11.6% y/y in May) in order to survive in foreign markets. **Deflation is thus well-entrenched**.

14. **In general, the pricing power of firms in the OECD area is very poor.** The main reason is the huge amount of slack that exists at this point. It will not go away quickly, given the situation of order books. Price wars will persist for the foreseeable future.

15. To become profitable again, **firms have to improve productivity by reducing their work force and cutting wages.** For a single company this may be rational, but if everybody is doing the same, the result will be a further decline in demand, or a slower recovery. Wages are both costs and incomes. **How can profits recover in a meaningful way if output volumes are either stagnating or, at best, rebounding a little, while output prices are declining and unit labor costs rising?**

16. **Stock market analysts beg to differ.** As always, they see earnings per share rising at a brisk rate between now and next year. On Bloomberg, I see that **profits for the companies in the S&P 500 are expected to increase by 26%; for the EuroStoxx 50 the number is 20%, and for the Nikkei 225 it is 96%. This looks very much like wishful thinking**.

17. **Price-to-book ratios** on the basis of estimated 2009 earnings are still rather elevated: 15.2 for the S&P 500, 11.15 for the EuroStoxx 50, and 43.8 for the Nikkei 225. Only European stocks come close to the single-digit level that is appropriate for the present crisis. Among the major emerging markets, only Russia is really cheap at a p/e-ratio of 7.9 – investors demand a hefty risk premium.

18. Rich valuations are, of course, justified if profits can reasonably be expected to rise briskly from here on. But **as long as unused capacities remain so large, the best companies can hope for is to survive.** Only very few can dictate selling prices these days, the others are price takers whose main strategy is on the cost side – they must boost output per hour worked, and reduce wages and other input costs. Another alternative is to cut output prices down to marginal costs in order to boost market shares and volumes. In any case, **none of these strategies leads to a revival of inflation. The opposite is the case.**

19. **The global economy will probably grow again in Q3**, after a stagnation in Q2 and quarterly annualized declines of real GDP in the order of 7½% in Q1 and Q4. Inventories have been reduced vigorously in recent quarters and are now compatible with weak demand, they no longer act as an additional drag on production. All forecasts I have seen call for quarterly annualized growth rates in the order of 2 ½% to 3% through the end of 2010.

20. While this looks optimistic to me – because the banking problems have not been resolved, because unemployment is rising steeply, and because there is no one who could replace the US consumer as the engine of global demand - , **such rates of growth still mean that the output gap will not be closed.**

21. There is an additional problem that could, or does already, restrain growth: **rising protectionism.** This had been a key feature of the Great Depression of the thirties. As Pascal Lamy, the French head of the World Trade Organisation, has just warned in the Financial Times of Jul 4, free trade faces a severe test. The government bail-outs had constrained risk-taking "outside the familiar territories of national markets, and this was already affecting foreign direct investment (FDI), now forecast to fall 50 per cent this year. ... If there is less FDI there will be less trade." Another example for protectionism is the US stimulus package which contains "buy American" clauses.

22. As the IMF has recently predicted, the **volume of world trade is declining at double-digit rates at the moment, and freight rates are at rock bottom.** The advantages of the international division of labor, an important source of our wealth, are getting lost. International cooperation is clearly lacking, at a time when it is most needed. All countries revert to national solutions. The UK had a first shot at beggar-thy-neighbor policies by devaluing the pound. Competitive devaluations did a lot of harm 65 years ago.

23. **Unemployment will therefore increase and then stay high for years to come.** This means wage inflation will fall, and consumer prices will either stagnate or decline. It also means that **central banks are likely to keep their feet on the accelerators** because they have not given up on their target inflation rate of about 2%. The ECB will probably cut rates to ½% or even ¼% (Mr. Trichet has left the door wide open for such moves last week), provide as much long-term liquidity at those rates as banks will take (and have collateral), and then become more aggressive in terms of "unconventional" quantitative easing measures as well.

24. **Without healthy banks it will not work**. It seems to me that the main mistake made by Japanese policy makers in the nineties, in the aftermath of burst equity and property bubbles, was to allow banks to keep bad assets on their balance sheets. Loans were rolled over endlessly at interest rates close to zero. Balance sheet ratios were disastrous, and did improve only very gradually.

25. **The same mistake is made today by US and European politicians**. It is admittedly not easy to sell to the public the idea that banks – which got us into this mess in the first place – should offload their non-performing assets into bad banks to the tune of several hundred billion euros, at prices close to book values, underwritten by the taxpayer, and after there had been various extremely expensive rescue operations already. But it must be done at some point, and the sooner the better.

26. **Bad banks are essentially asset managers** which try to sell the toxic assets at the highest possible prices, but patiently and not in fire sales. The state would temporarily become a majority shareholder in the banks that have been rescued, and it should not shy away from changing management and business models.

27. **To be realistic, lending in the key OECD area countries will most likely continue to stall** because for political reasons the problem of toxic assets on bank balance sheets cannot be solved, at least not in the near-term. **Economic growth will therefore be anemic after the technical rebound that is presently taking place.**

28. **Raising pressure on banks to step up lending to industry and households is almost useless.** Lending will only be increased if it makes business sense. In Germany, the government has announced it will have to sit down with the Bundesbank to look for a solution if lending does not pick up in the second half. Mr. Putin had said something to the same effect.

29. **In the four largest economies** – the US, euroland, Japan and China – GDP-weighted **consumer price inflation is now -0.9% y/y**. Had oil prices not increased considerably since last December, the inflation rate could well be at -1.3% already. In the rest of the world inflation is also on the way down.

30. This includes **Russia**, the only significant outlier (+12.3% y/y): since real bank lending there is declining steeply, while real wages are falling, it is almost a forgone conclusion that inflation will reach single digits this fall. As mentioned earlier, producer prices in the key countries are falling, and wages will soon fall as well.

31. **Overall, bonds of solvent governments are well supported: money market rates are, and will remain, very low, inflation will turn into deflation on a global scale, as commodity prices adjust downwards again, and sub-par economic growth is bad for equities, the main alternative asset.**

32. Which bonds are best for the international investor depends crucially on what happens to **exchange rates**, especially to euro-dollar.

33. **The dollar benefits** from the rapid improvement of America's balance on current account, the consensus view that the recession will be less deep than in Europe (or Japan) and therefore the prospect that money market rates will soon be more attractive, and that surplus countries such as China, Russia or the members of OPEC continue to add dollars to their foreign reserves. The dollar is also significantly undervalued from a purchasing power parity point of view.

34. **On the other hand, investors are obviously scared about America's super-easy fiscal and monetary policies** which reflect the aggressive attempt to bring back inflation and growth. To some this looks reckless. The budget deficit will hit 13% of GDP this year and then remain in double-digits as far as the eye can see, which is in contrast to the more conservative European approach. In spite of a much lower inflation (actually deflation) and much lower money market rates, US government bond yields are almost 20 basis points higher than Germany's. Then there is the Damocles sword of Chinese and Russian challenges to the dollar's reserve currency status. This is perhaps not such a significant danger because diversifying into euro, yen, or SDRs would be self-defeating for the sellers.

35. **More serious is the danger that the US has a growing incentive to get rid of the real burden of the debt** vis-á-vis foreigners (mostly denominated in dollars) and residents alike by promoting high inflation, seventies style. Should the dollar lose its appeal as store of value it could crash. This scenario is what keeps central bankers around the world awake at night.

36. I would guess that the latter is not a genuine risk in the near term. But if the US recession drags on longer than currently expected (because consumers are discovering the virtues of higher savings), while unemployment moves beyond 10%, it could become a viable policy option. The euro area is much more conservative about inflation, and so far also not so dependent on one national government as the Fed. In this respect at least, the euro is a more solid currency.

37. **The yen is once again becoming a safe haven**. Deflation is almost a way of life in Japan and not such a threat to economic growth as in the US. Because the balance on current account has a structural surplus, there is a steady demand for yen. Firms have learned to cope with an overvalued currency.

38. **The main long-term development that needs watching is the yen-renminbi cross rate**, as China has become the main trading partner and destination for direct investments. As long as the yen does not appreciate against the Chinese currency, the dollar exchange rate may do what it wants, I would assume.

39. So what is the conclusion? I would not **be surprised if, a year from now, the euro would** trade at $1.60 again, and the dollar at 90 yen. This means a EUR-JPY cross rate of 144. Looks like I have a home bias!

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