



Wermuth's Investment Outlook

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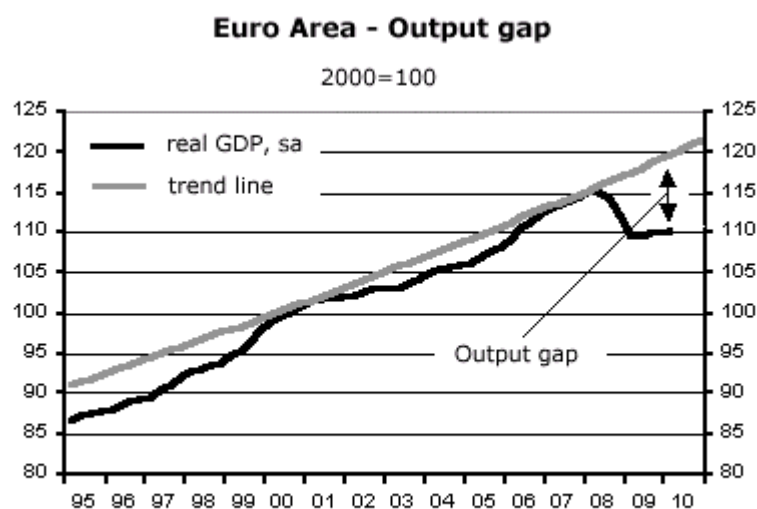
- 1. The world economy is in good shape. A double-dip recession is only a remote risk.** Emerging economies expand briskly and remain the locomotives of global growth, but are close to overheating; inflation there has accelerated. Countries in the OECD region continue to rebound from the Great Recession of 2008/2009. Since their output gaps are still very large, core inflation continues to fall and may soon reach zero, which in turn allows central banks to maintain their expansionary policies. Efforts by governments to bring down budget deficits in a pro-cyclical manner are not of immediate concern.
- 2. Globally, ample liquidity and low real policy rates support bonds, commodities and equities. Stock markets benefit additionally from the recovery of final demand and the productivity gains** that come with rising rates of capacity utilization. Their main worries are the possibility of sovereign and bank defaults in Europe, the effects of deleveraging US households, and a property crash in China.
3. There is always the possibility that things can go wrong, but at least for now the news from the real economy, from inflation and from monetary and fiscal policies is overwhelmingly positive. Because momentum is so strong, it is almost certain the **global real GDP**, calculated in purchasing power terms, **will exceed its 2009 average by about 4½%** this year which is not much different from pre-crisis growth rates. In terms of actual exchange rates growth will be in the order of 3½%, the product of 2.7% in developed economies, and 7.0% in the rest of the world.
- 4. As usual, industrial production will expand even faster, perhaps by 7 or 8% y/y**, and the volume of world trade by still more, in the order of 12%. This reflects two secular trends. One, people in the poor countries of the world are keen to buy goods, such as cars, houses and consumer electronics while services are further down their shopping lists. This is why industrial production expands faster than global GDP with its large services component. Two, the international division of labor continues unabated. It is a major source of the world's huge advances in productivity.
- 5. Market participants are in general less upbeat than I. They suffer from “model uncertainty”, meaning they have a problem understanding what is going on and where it will all end. They suspect that policy makers are equally at a loss. How long will China's economic miracle last? Are we heading toward inflation or deflation? How high is the risk of a sovereign default or of a major bank? What will money printing by major central banks do to the long-run stability of the currencies? What will be the fallout from deleveraging American, Japanese, Spanish or East European households?**

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6. **Several indicators support the thesis of unusual uncertainty:** the extremely high gold price, the flight into German, Scandinavian, Swiss and even US government bonds, the widening of yield spreads of lesser-quality bonds over benchmarks, the relatively low valuations and high risk premia of most equities, and statements by the ECB, the Fed and the Bank of Japan that expansionary policies will persist for the foreseeable future.
7. **This is, of course, a time when level-headed investors can lay the foundations of long-term success. So let us have a look at the risks, real and perceived.**
8. I start with the **question whether China and the other emerging and developing economies can keep growing at those high rates.** In the eight years to 2009, their average real GDP growth rate has been no less than 6.3%, compared to 1.6% in advanced economies. The IMF predicts that this large discrepancy in performance will basically persist over its forecast period to 2015 (6.6% versus 2.3%). We thus have to get used to the notion that the OECD countries are no longer the drivers of global growth. This had to happen at some point, and the point is now. After all, their share in world population is only 15% (see IMF World Economic Outlook, April 2010, pp. 148 & 155).
9. **Emerging countries will not be stopped in their race to reach western living standards.** People are quite aware of how poor they are, thanks to the ubiquitous television. So they work hard, save a lot, and invest a lot, relative to their income. This is a recipe that has by now made their countries largely independent of capital imports from the rich part of the world - or of IMF interventions, for that matter. Their expansions are increasingly self-sustaining and less dependent on merchandise exports to the OECD countries. In fact, they are, as a group, net capital exporters.
10. Economists had usually been convinced that emerging markets' real growth rates of more than 6½% a year - or more, in the case of China - can not be maintained for a long period of time. Sooner or later something called **overinvestment** will make itself felt.
11. They argue that euphoria about growth and potential profits inevitably leads to a stock market boom and a concentration of resources in housing, steel, mineral extraction or shipbuilding. Central banks typically begin to tighten in such a situation. Together with the steep decline of expected rates of return, caused by the oversupply in these sectors of the economy, this leads to a **stock market crash, followed by a recession. This has been the typical pattern in 19th century Britain, France, America and Germany.**
12. But back then these countries were at the forefront of the world's industrialization process. Today's "backward" countries are not. **There are role models that they can follow**, and they are aware of the mistakes that must be avoided. War-ravaged and impoverished Western Europe and Japan had achieved, over a quarter of a century, rates of productivity and real GDP growth which are comparable to those of today's emerging markets. Aggressive saving and investing, undervalued exchange rates, plus conservative fiscal, combined with easy monetary policies were the key ingredients of their strategy, while state-of-the-art technology could be bought on world markets and had not to be developed from scratch as in those 19th century countries. Europe and Japan had also been large net capital exporters during their catching-up years – it did not harm them.
13. In other words, I suggest, just as the IMF, that **emerging economies – which by and large follow this model - will continue to grow strongly for years to come.** I assume that they can survive the occasional asset bubble and will be able to keep their exchange rates

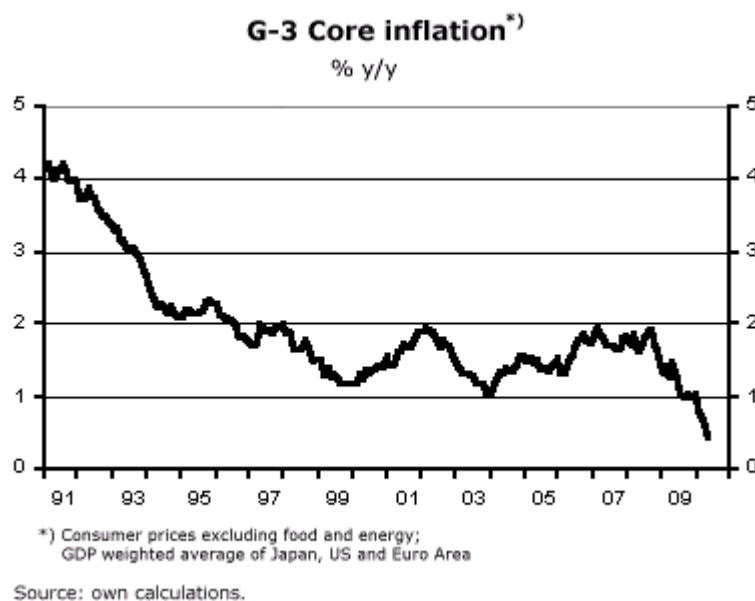
competitive. It is in a way a new world, and analysts and the public have not yet taken notice. But it is not a reason to complain about model uncertainty: the growth model is actually well established.

14. If reality does indeed move along the lines described above, this would **put a floor under most commodity prices and benefit directly countries which produce what the BRICs and other newcomers need**, including the whole range of consumer and capital goods as well as certain services. In the final analysis, robust global growth helps everybody, and mitigates the fight for shares in national income. In this sense it is also positive for peace and stability.
15. As an aside, the prospect that 7 billion people will soon consume as much energy and other natural resources per capita as Americans is of course scary and not sustainable. Economists like myself would point out, though, that the resistance to the **degradation of the environment** is a function of the standard of living – Green parties have only been founded in rich countries –, and that rising commodity prices will not only boost supply but also reduce demand and thus the strains on the environment. There is no lack of tools with which to reverse course. If there is a will, there will be a way. It is clear, though, that the global environment will deteriorate for some more years before it gets better.
16. **Inflation or deflation? I do not see a danger that the world as a whole will suffer from rising inflation and deny that there is really model uncertainty in this regard. In developed economies, the main theme is still disinflation.**
17. In the **euro area**, for instance, first quarter real GDP was no less than 7.8% below the trend line that connects the cyclical highs of Q1 2001 and Q1 2008. In spite of the recent economic recovery the **output gap thus remains huge**. When capacity utilization is low, competition is invariably intense which makes it difficult for firms to raise prices. They also don't have a strong incentive to do so because profits will rise steeply in any case as long as they can increase output and productivity. In addition, **record high unemployment** (10.1%) will hold down wage inflation in the euro area. Even in Germany where unemployment has been falling since last autumn (to 7.7%), labor costs presently contribute to disinflation. In Q1, hourly wages were down 0.2% from one year ago and thus -1.0% y/y in real terms.



Source: Eurostat; own calculations.

18. **The American output gap is smaller than euroland's:** the recession had been less deep and the recovery that began in the third quarter of last year has been strong, helped by a massive fiscal stimulus and a nominal policy rate of almost zero. Real GDP is expected to exceed its 2009 level by 3.0% this year. But the **labor market is still depressed**, with 15 to 20 million workers looking for a job, and an unemployment rate of 9.7%. Real personal income was up by just 0.5% y/y in April. Many households are still struggling to repair their finances after the steep decline of house prices (in March they were down 30.6% from the July 2006 high, and are falling further). The reduction of debt levels has priority for them which does not bode well for consumer demand – but is of course positive for inflation.
19. In the three largest economies, the US, the euro area and Japan, the **aggregated core consumer price inflation (which is headline inflation ex food and energy) has reached 0.5% y/y (April) and thus continues its apparently unstoppable move toward the zero line.** Core inflation is regarded as a fairly reliable leading indicator of headline inflation. Central banks will have no problem defending their easy policies in such an environment. It is more difficult to fight deflation than inflation.



20. **Inflation is more of a problem in emerging economies.** It will probably average around 5% this year. The IMF had still forecast 6.2% y/y last April. While the outlook has thus improved somewhat, central banks in Brazil, Peru, India, China and other East Asian countries are all in a tightening mode (just as commodity exporters Canada, Australia and Norway – but not Russia). Note that even in this part of the world, output gaps are rather large - which tends to keep inflation in check.
21. Raising interest rates must not necessarily lead to a recession, though. In general, policy rates are a lot lower than the growth rates of nominal GDP (these are a proxy for the elusive concept of equilibrium interest rates) - and thus anything but high. **Monetary conditions in emerging and developing economies remain expansionary.**

22. All this means that **government bonds are well supported, especially those of countries with a good and stable credit rating.**
23. This brings me to a **third kind of model uncertainty - the possibility of sovereign defaults.** Investors have become very selective and shun sovereign issuers whose deficits and debt levels look dangerous.
24. **Euro zone member state Greece**, with its 10-year bond yield of 9.45% right now, is totally out of favor (German bonds are only 2.75%). In spite of the bail-out which will enable the country to refinance its debt for the next three years on favorable terms (at an interest rate of somewhat less than 5%) a default is seen by some as almost inevitable: debt levels are approaching 125% of GDP, most of that debt is owed to foreigners, the economy may shrink by perhaps 6½% this year, and the government deficit must be reduced by at least 3 percentage points compared to 2009. Currency devaluation is not an option. On the other hand, Greece is a small country (2.6% of euro area GDP). It would not be too difficult to mobilize additional help if necessary. The cost of any rescue package will be less than that of a chain reaction triggered by a Lehman-style default which would bring down the European banking sector. **A Greek default is thus not an option. The same holds for Ireland and Portugal who are also in the line of fire.**
25. **The more serious problem is Spain where unemployment is almost 20%.** Its share in euro area GDP is 11.7%. There had been a big property bubble during the first nine years of the euro, caused by a large decline of real interest rates in the wake of Spain joining the euro area. Between 1998 and 2007, residential property prices rose by 173% (ECB Financial Stability Review, June 2010, p. S24). At some point during those years, Spain produced almost six times more residential units per capita than Germany! Property prices have only begun to fall, it seems, which means the full impact on household and bank balance sheets has yet to materialize.
26. At the same time, the **Spanish general government deficit will be in the order of 9.8% of GDP** this year, after 11.2% last year (EU Commission, European Economic Forecast, Spring 2010, p. 94). The government has taken drastic actions to reduce the deficit, but it means that real GDP will continue to fall, and that unemployment will almost certainly pass the 20%-threshold. One positive element in all this is Spain's relatively low level of government debt (expected to be 65% of GDP this year). 10-year bond yields have increased steeply to 4.46% today. Bad as this is, it is less than half as high as the yield on Greek bonds. At these yield and debt levels, debt service is very painful but looks manageable. It also helps that the Spanish government has unilaterally decided to publish the stress tests of its banks. Crisis prevention requires as much transparency as possible.
27. Especially **French and German banks are heavily exposed to Spain** (\$248 bn and \$202 bn, respectively, at the end of 2009, according to the June BIS Quarterly Review, p. 19). Banks headquartered in the euro zone had an exposure of \$1,579 bn to Spain, Ireland, Portugal and Greece, the four countries facing market pressures (p.18). This is the equivalent of 14.1% of euro area GDP.
28. On balance, the European debt problems can be handled I would guess. The rescue package that had been agreed in cooperation with the IMF has a total volume of almost \$1 tr, and can probably be increased if necessary. What is disquieting from a longer-run perspective is the lack of a road map toward a fiscal union. Nothing on a big scale needs to be done in this respect right now, but it is clearly not enough to just introduce new sanctions into the

Stability Pact. The pact is ineffective and needs to be replaced by something that is weatherproof. **Investors are right to suspect that a currency union cannot survive without closely coordinated fiscal policies.**

29. **Europe's troubles are considerably alleviated by the weak euro in combination with the recovery in international trade.** Especially Germany has benefited: real incoming orders to manufacturing from abroad were up 28.7% y/y in Q1 (total orders +23.7%). Exports are booming once again, even though they are still far below the levels of 2008, and the forecasts for 2010 real GDP have been revised to +2.1% y/y (by the country's research institutes). The public sector deficit will rise from 3.1% of GDP in 2009 to 4.4% this year, which is a much smaller deficit than had been feared not long ago. German stocks will do increasingly well in the improving international environment.
30. Investors with some sense of history are afraid that **the huge deficits of American, British, Japanese, Spanish or French governments will in the end ruin their currencies.** Deficits are as high as after major wars, and efforts to bring them down look half-hearted so far. In case the economic recovery loses steam, will the deficit ratios simply be increased by another notch? It may not be possible. Hasn't the Greek crisis shown that there is a limit to how much a country can borrow? At some point, access to capital markets will be denied – which means the country has to default. Is this a realistic prospect? **There is certainly widespread model uncertainty in this regard as well.**
31. **If most of the government debt is held domestically and if a country's foreign assets exceed its liabilities, there is not much of a problem.** It's an intra-family affair, so to speak. Japan, where this is the case, finds it easy to roll over its gross public debt of no less than 200% of GDP. The test will come once the Bank of Japan has to raise interest rates in response to accelerating inflation and a higher rate of capacity utilization. But this continues to be a remote risk. Policy makers would love to bring about inflation and don't know how to do it. They are also relaxed about debt levels for another reason: higher inflation would boost state revenues which makes debt service a smaller burden. Moreover, government deficits tend to melt away quickly during a robust and long-lasting economic expansion cum inflation.
32. **American and British governments are in a more difficult situation because their economies are running current account deficits.** Even they find it easy to service their debt: their currencies are quite strong, and real bond yields are low. Foreigners are not demanding much in terms of risk premia. The new British government is very aware of the risks posed by the large budget deficit and is taking action while the US administration is quite relaxed in this respect, assuming that the dollar's status as the pre-eminent reserve currency will always generate enough capital inflows to cover any shortfall. This looks dangerous to me. The success of the strategy depends crucially on continuous economic growth, more precisely on strong consumer demand, corporate capital spending and a competitive exchange rate.
33. **Since the US household sector is so heavily indebted (if not in net terms) deleveraging, ie forced saving, is still the order of the day.** It is almost frivolous to bank on consumer demand for growth. The strong dollar, on the other hand, is exactly the opposite of what the doctor would order. **I think a depreciation can not be avoided.** A shift from government and other domestic demand to foreign demand, while preserving the growth momentum, requires an adjustment of the exchange rate, i.e. a new set of international prices. In this

sense, the large budget deficit does in the end lead to a weakening of the currency, just as skeptics would expect.

34. **So, from an investor's perspective, what is the bottom line? Strong growth in emerging economies argues for investments there. As valuations are quite high, investors could move instead into OECD area stocks of firms which do good business in this region. Commodity producers and distributors are another idea in a high-growth global environment. Government bonds of low-budget-deficit countries will probably perform well as long as large output gaps point to low and falling inflation as well as expansionary monetary policies. The yuan will appreciate from here on against the dollar, after the announcement of greater exchange rate flexibility this weekend, but better bets are the yen and the euro. Especially the latter has taken a beating and is now very competitive. European sovereign risks are considerable but look manageable for the next couple of years. How about a little diversification into Greek bonds?**

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