



Wermuth's Investment Outlook

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1. For investors, private or institutional, the **prospect of very low inflation and very slow growth** is quite scary. While it is not a foregone conclusion that this is where the global economy is heading, the likelihood of such a scenario is not small. Japan looms large, especially in countries which are in a post-bubble deleveraging mode.
2. I argue that, as far as rich countries are concerned, one should be prepared for a long period of lackluster corporate earnings and stock markets as well as unusually low yields on high-quality bonds. Portfolios should be reshuffled accordingly. This implies that **the weight of income stocks must be increased relative to growth stocks**.
3. Since most **emerging economies** have been able to resume their race to catch up with rich countries, they are rapidly closing their output gaps – which were mostly rather small in the first place. With some exceptions, **deflation is not a risk for them**: their financials are sound, with only a modest degree of leverage. Deleveraging and holding back on spending is therefore not an issue for them. Actual inflation is somewhat more than 5% y/y, compared to about 1¼% in developed markets. There is also no reason to doubt that trend growth in the BRICs and most other Asian and Latin American countries will remain in the order of 6 to 7%. Together with attractively high risk premiums, i.e. low valuations, **this calls for allocating a rising share of funds to that part of the world**.
4. Overall, **the initial phase of the global economic recovery which was characterized by rebuilding inventories and brisk industrial production has come to an end**. As real GDP growth has slowed to 2 to 2½% in the second half of this year, or to less than potential, output gaps are widening again. This keeps inflation down.
5. **Real global GDP will expand faster from early 2011 onwards**, perhaps in the order of 3¼% annualized at actual exchange rates, but growth will not be evenly spread. The drivers will be emerging economies, including Russia, and those OECD countries which either do not suffer from the repercussions of burst real estate bubbles and can handle their banking crises, such as Germany, Scandinavia, Holland, Austria and Switzerland, or commodity producers such as Australia, Canada and the OPEC. Problem countries are those that are either deleveraging or are forced to cut government budget deficits aggressively, or both. This includes the US, Britain, Spain, Greece, Portugal, Ireland and most East European economies with the exception of Poland and Russia. France and Italy are somewhere in-between.

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why low interest rates are there to stay

6. **Monetary policies in industrialized countries will remain expansionary as far as the eye can see**, for two main reasons: first, output gaps are still large, unemployment is high and inflationary pressures are thus subdued or non-existent; most **central banks feel that inflation is too low** and should please accelerate. Second, the **health of the banking sector has not yet been restored** because a large share of its assets is of dubious quality; in order to strengthen the ability to absorb losses and to meet the new Basel III requirements, the equity base needs to grow considerably.
7. For policy makers, the easiest way to achieve this is via a persistently steep yield curve, meaning short-term rates must stay well below long-term rates, as banks typically borrow at short maturities and invest long. Such a strategy leads to wide interest margins and also tends to drag down the whole yield curve which in turn results in capital gains on bonds. New investors are, of course, less happy about those low nominal yields.
8. **There is a disturbing aspect to low interest rates**: in order to maintain the present lifestyle after retirement, people have to save considerably more than they had expected when rates were higher (see page 80 in the September 19 Economist). If you earn 2% on your investments you must, because of the effect of compound interest rates, save more than twice as much as if interest rates were 4%, to end up with the same amount of capital. In fact, if the time horizon is, for instance, 40 years, one has to save 3.15 times more every year than at 4%. Seen from a different angle, if you want to live on interest income alone after retirement the capital base must be twice as high if future interest rates are expected to be 2% rather than 4%, assuming you want to preserve the capital for your children.
9. **Low interest rates do thus not necessarily stimulate borrowing, spending, growth and inflation, they can also be a big pro-cyclical boost to savings and can thus reduce domestic spending. They have a deflationary effect.** The recession may then become entrenched, especially in countries without the safety valve of foreign demand, i.e. countries where exports have only a small share in total demand. Life insurance firms and pension funds are pushed into riskier assets on the one hand, and dividend stocks on the other.

large parts of the world are in deleveraging mode

10. Recent studies by Carmen and Vincent Reinhart as well as Ken Rogoff have raised the awareness of what a **major financial crisis** such as the recent one will typically do to the real economy. According to the authors, it is almost certain that post-crisis real GDP growth will be considerably lower than in the years before the upper turning point in output.
11. **Unemployment will prove to be stubbornly high, and output gaps do not go away easily.** Workers have then no means to bargain for substantial wage hikes. Inflation will therefore be subdued for several, or even many years, and central banks will keep interest rates low for a long time. The Fed and the Bank of Japan have recently been very clear that they will do exactly that (while the ECB wants to exit its “unconventional” policies).

12. Note that a financial crisis is a very different animal from a normal recession triggered by a tightening of monetary policies in response to accelerating inflation. **If asset price deflation and deleveraging prevail the stimulus from lowering interest rates and boosting base money can be disappointingly small.** If my goal as a borrower is to get creditworthy again, I cannot easily be tempted to increase my debt, even if the terms are more attractive than usual.
13. **Fiscal policies can also be ineffective unless the government goes all the way**, like in a major war, as Paul Krugman keeps suggesting, ie borrow to the hilt and fully replace the lack of private demand with government spending. He says that once the economy is expanding vigorously again, debt levels will come down quickly, while inflation stays subdued for an extended period, as after World War II.
14. Not only in the US are **such proposals fiercely opposed by politicians and the public**. No one believes the situation is as serious as in 1939 – there is no genuine foreign enemy. Moreover, the budget deficits are considered to be much too large already, debt levels are rising rapidly relative to nominal GDP, and haven't we all learned over the past 40 years that fiscal policy has no role to play in boosting growth? Not easy to bid farewell to a theory that still dominates both the economics departments and the media.
15. In other words, **a further round of massive fiscal stimuli is not on the horizon**. The Japanese government has never succeeded to borrow enough to really fill the output gap and in this way keep potential GDP on a steeper growth trajectory. There is simply no successful role model to follow at this point in countries which are in deleveraging mode. Japan itself is still struggling: its major stock market index remains stuck at about 25% of where it was at the end of 1989, nearly 21 years ago.
16. **The weakness of private demand in the deleveraging part of the world – accounting for roughly 40% of global GDP at current exchange rates – will not go away easily.** Unless there is a major demand shock which results in a big increase in spending, it will take years before debt levels are back in "normal" territory again. Only then will households and firms dare to borrow again. I expect that this group of countries will remain the major drag on the world economy.

the US has almost exhausted its policy options ...

17. **The US, because of its large weight in world output, will be the swing factor going forward.** Its growth is tepid, considering that it is still early into the recovery from the previous recession. Normally, at this stage in the cycle, the economy should be expanding at quarterly annualized rates of 6% rather than the present 1½ to 2%. Output gaps are rising again.
18. **The American labor market actually suggests that the recession is not yet over -** unemployment, at 14.86m and 9.6%, is still more than twice as high as in the spring of 2007, while the number of jobs is not rising any more since last March and, at 139.25m, continues to be 4.9% below the peak of November 2007.
19. The Fed has cut interest rates to almost zero and has pumped money into the economy, to not much avail. **A further round of quantitative easing is now generally expected.** The problem is that the so-called money multiplier (the ratio of central bank money to M3/bank

lending) has broken down because the private sector is preoccupied with the reduction of debt. As it is, making more money available does not affect debt levels. There has been some debt reduction in the private sector since the first quarter of 2009, but this has been concentrated in the finance industry.

20. **US households have barely begun to work off their mountain of debt**, and they face new difficulties as house prices are on the brink of falling again: the number of housing starts considerably exceeds the number of new homes sold. Almost a quarter of households have negative equity which means their mortgage debt is larger than the market value of their homes. They cannot sell, they cannot move, they must try to spend as little as possible. For the foreseeable future they won't be the world's consumers (and importers) of last resort any more.
21. **Fiscal policies are not of much help either**. They will stay expansionary and thus help to fill some of the demand gap created by the reluctant spending of the private sector, but there is now a strong political resistance against even larger budget deficits. The risk is therefore that policies may soon turn pro-cyclical, and contribute to a new recession.

... except for the FX option

22. US policy makers have clearly run out of the standard options and begin to consider other strategies. Quantitative easing has been one and will be tried again, but more dangerous ones, for both the US and the rest of the world, would be **protectionism and a politically motivated devaluation of the dollar**. The former is now a big topic in Congress and has a lot of popular appeal, as always when times are bad. So far, there is more talk than action in this respect. Calls for a depreciation of the dollar against the renminbi are getting louder, though, and are showing some early if modest results: since China ended the fixed-exchange rate policy in mid-June, the dollar has fallen by 2%.
23. **For FX policies to have a positive impact on the US economy, it is, of course, easier and more plausible to depreciate the dollar against the European currencies and the yen**. Neither the ECB nor the Bank of Japan will buy dollars against their own currencies, i.e. give up their freely floating exchange rates in order to put a limit on their appreciation. The Japanese have recently intervened a little but the strength of the yen (against the dollar and, by implication, against the renminbi) is not really excessive at this juncture. So they have stopped again. Could also be that the MoF got an angry call from Mr Geithner.
24. In other words, **if the US Treasury were to buy euros and yen, it would probably meet little resistance and could indeed bring down the value of the dollar, increase price competitiveness, reduce the trade deficit and boost domestic employment**. The option has not yet been exercised. Such a policy would amount to a sea change for the US – the issuer of the main reserve currency is not supposed to do that. It would amount to a loss of seigniorage: borrowing from foreigners would no longer be as cheap. Moreover, in the post-war period dollar sales on FX markets have always been consensual, as after the Plaza Accord of September 1985, rather than confrontational. If the US proceeded unilaterally – selling (printing) dollars, buying yen and euros in the open market - this would be considered a so-called competitive devaluation, a hostile gesture, and even a declaration of an exchange rate war.

25. **The present weakness of the dollar is driven by market forces** and does not reflect an explicit strategy change by US authorities. To be sure, though, announcing that policy rates will remain very low for very long, discussing another round of quantitative easing and exerting pressure on the Chinese to stop buying dollars can be interpreted as a soft-dollar policy, a sort of verbal intervention, so to speak.
26. Investors can be forgiven to think that it is **fairly riskless to use the dollar in carry trades**, to borrow dollars and exchange them for assets denominated in currencies which have fundamental upside potential, such as the yen, the euro, sterling, the Swiss franc, the Swedish krona and so on, even the rouble. Once this perception is widely accepted, the dollar will fall a lot more. The continued strength of US Treasury notes and bonds shows that market participants are not worried that this will automatically lead to higher inflation in the US. From an American perspective, the depreciation has so far been painless – and is something the doctor would have prescribed.
27. A remark about **US corporate profits**: as a proportion of national output they are very near a historical high (12.3% at the end of Q2). This is surprising at such an early stage of the recovery. It suggests a structural change: the division of the pie between capital and labor may have durably moved in favor of capital. Labor has not much bargaining power any more in this era of open borders and the downward pressure exerted indirectly by Chinese and Indian workers on wages in the US (and other countries). Organized labor is unable to put up much of a fight. That profits do so well does not mean that the US is in the middle of a new boom – they are rising at the expense of labor income. Over the past four years, the total wage bill has not increased! This explains perhaps why the (2010 earnings) S&P 500 price-to-earnings ratio is just 13.6: American stocks are cheap but growth expectations are depressed.

Japan remains stuck in deflation

28. **Deleveraging is also an issue in Japan**, after almost twenty years of shockingly slow economic growth and moderate deflation. Demand for goods and services is upheld by government deficits in the order of 7 to 9% of GDP, and by exports to buoyant neighboring markets. One problem is that the banking sector still carries a huge amount of non-performing loans on its books, not least because low interest rates make it easy to roll them over. With short interruptions, bank lending shrinks since 1994. Another problem is the poor financial situation of households: employment is declining since 1997 (for a total of 5.1%) and nominal household incomes have fallen for more than a decade as well. In this respect the situation resembles that of the US: labor is under pressure but corporate profits are rising briskly from their recession lows, perhaps by 40% y/y in 2010.
29. Japan's front yard is populated by the most dynamic economies of the world, and it has the products that are needed there. **The strength of the yen is not more than an irritant**; compared to 1995, and adjusted for inflation differentials vis-à-vis trading partners since then, it is actually rather cheap and not really overvalued. The same holds for the stock market which trades at a p/e ratio of 16.4 (2010 earnings). **Even bonds are not overpriced**. The yield on 10-year government bonds is 0.91% while inflation expectations are somewhere between -0.5 and -1.0%. The real yield is therefore much higher than in the US or the euro area. An additional advantage from a foreign investor's point of view is the inherent strength of the yen exchange rate. **The yen will continue to appreciate**.

the euro area has begun to leave its problems behind

30. **Spain, Greece, Portugal and Ireland which together account for 18% of the euro area's GDP are all undergoing severe adjustment processes in order to avoid default.** International media are almost unanimously predicting defaults anyway, while no one in the four countries or in Brussels believes that these are inevitable. Their main point is that growth rates have been so rapid in the past, and living standards so high that even a drawn-out recession must not necessarily be a catastrophe. Only a few years ago, Ireland's per capita GDP was no less than 30% higher than the euro area average. The Spanish also feel that they have struck a very good deal by joining the euro.
31. **Some belt-tightening is generally not regarded as unreasonable.** Policy makers have by and large convinced the voters that the growth model based on low real interest rates and a borrowing binge by households is not sustainable and that resources must be channeled away from private and public consumption into building a productive capital stock and promoting exports. Even if the governments opt for defaults, they cannot avoid restructuring their economies in this direction. No matter what, the process will be painful, and in any case, the recessions that these deleveraging countries are now facing are relatively mild compared to what Germany and Japan had experienced in 2009. Or take the three over-indebted Baltic countries: their output has declined by 10 to 20% - and they are not even inside the euro area.
32. **Bond markets seem to acknowledge that the chances of a benign outcome in the euro area periphery have improved lately.** 10-year Greek government bond yields have fallen from 11½% a few weeks ago to 9.8% now. By the way, this still represents a good investment: the 6¼% bond maturing in June 2020 can be bought for a price of 78.2. So even in the case of a 20% haircut after a default investors would come out on top, with a current yield on their money of 8%. If I had an aunt I would tell her about this opportunity.
33. **Ireland and its banks have become more of a concern lately: bank rescues will drive the budget deficit to over 30% of GDP this year.** But markets are convinced that the operation will nonetheless be successful. They are even more convinced that Portugal (6.1% for the 10-years) and Spain (4.0%) will make it.
34. The most astonishing aspect of this European crisis is the **absence of Italy from the front line** (3.7%). Why is this? Isn't Italy a country with one of the world's largest government debt ratios and thus one of the usual suspects? I think the main reason is that the debt is held mostly domestically (the same as in Japan) and that the savings ratio is one of the highest. Moreover, because there had been no housing boom to speak of there was also no bubble that could have popped. Somebody has also said that Italian banks did not have the computer systems in place when they were offered supposedly high-yielding American collateralized debt obligations which later turned out to be toxic. In other words, their "backwardness" saved them, prevented them from making costly mistakes.
35. The bottom line of this section is that the European debt crisis will gradually fade away. The larger part of the currency union is in fairly good health and will not be thrown off-track by the recessions in the countries which are forced to deleverage aggressively. The ECB, notwithstanding its intention to get back to "normal" will remain accommodative in

order to get the banking sector back to health and, a new aspect, prevent the euro from appreciating too much. After all, core inflation which is usually the bellwether of headline inflation is in the order of 1% and falling. The inflation target of “just below 2%” will be missed on the downside for some time to come.

Germany in an unusual role

36. **On the sunny side of the global economy are presently Germany and its neighbors, the commodity producing countries and most of the emerging economies, especially China. Together they account for about 60% of global GDP. None of them has serious debt problems and needs to deleverage. They are pulling the world economy forward right now.**
37. Going by recent labor market data, the Ifo Indikator and incoming orders to the manufacturing sector it would be surprising if German output had not grown briskly in Q3. The second quarter's 9% annualized growth rate of real GDP will certainly not be repeated, but something around 4% looks feasible. For the year as a whole, the **consensus forecast calls for a growth rate of 3.4% y/y, followed by 2.5% next year.** At 40.4m, employment now exceeds its post-unification high of September 2008, and unemployment has declined 15 months in a row to 7.5% in September. Consumer confidence is rapidly improving and is near record levels. Consumer confidence! The volume of imports of goods and services will probably exceed last year's level by about 14%. To be the growth engine of Europe is a rather new sensation for geriatric Germans.
38. To be sure, real GDP declined by no less than 4.7% y/y in 2009. So in spite of the recent buoyancy, **output gaps are very wide** – according to my preferred calculations, the one in industry is around 12%, the one for the economy as a whole about 6%. This is the main reason why consumer price inflation is just 1% y/y. It could fall further. Since productivity reserves are still substantial, there is no risk that inflation will accelerate.
39. **The low rate of capacity utilization also bodes well for corporate profits whose share in national income rises since the middle of last year** as output growth exceeds the growth rate of employment and working hours. The main stock index trades at a modest p/e multiple of 11.2 (2010 earnings). Just as in other countries, investors are not optimistic about future profits. In the case of Germany, this may not only reflect the expectation that growth will soon be back to normal, i.e. anemic, but perhaps also the fear that the euro may appreciate too much, hurting the international competitiveness.
40. **Bunds are a good hedge against deflation and will also benefit from the recovery of the euro.** The country's economic research institutes predict that the government budget deficit will fall to 2.1% of GDP next year, after 3.4% in 2010 and small surpluses in the two years before while the current account surplus will be in the order of 5% of GDP. 10-year government bonds yield 2.24% today. More attractive proxies are Danish, Swedish, Dutch, Finnish and Austrian bonds– their liquidity disadvantage is compensated by yield pick-ups of 10 to 45 basis points. France is at 2.60%, Italy at 3.74.

China makes the world go round

41. Finally, a few words about the role of China from an investor's perspective. **The weight of the country's economy in global GDP is rising rapidly.** In nominal terms it has reached €3,950bn in the last four quarters including Q2 of 2010, using today's exchange rate. For comparison: Japan is at €4,127bn, the euro area at €9,039bn, and the US at €10,310. These are the four largest economies – they account for almost two thirds of the world's output.
42. **With trend growth rates of industrial production in the mid-teens and real GDP just under 10%, China has already become the largest market for a number of products** such as oil, cars, cement, copper, steel, railroads and housing, to name just a few important ones. In all these markets China is likely to increase the distance between itself and the runner-up for years to come. With a population of 1.3bn and a national savings rate of around 50% (of GDP), i.e. extremely sound financials, it pursues a successful growth strategy that is unprecedented in world history.
43. **Many analysts are skeptical and predict that China will soon hit the wall:** there are supposedly not enough profitable investment opportunities for all these savings. I argue that the country is still backward, especially in the interior provinces, with a huge underemployed labor force. For instance, why shouldn't the auto market eventually grow to 40 million units annually, from 15 million today? GDP per capita is still very low, only about 11% of the euro area's per capita output. There simply can be no lack of investment opportunities and of things people want to buy.
44. Another frequent argument is that **China must do more for its consumers** – the structure of growth is said to be lopsided and neglects the needs of households. This is simply not true. In none of the major countries is private consumption growing at a faster pace than in China: the past decade's average annual growth rate of 11.2% (in real terms) is hard to beat. The share of consumer spending in GDP is admittedly very small (35% in 2009), but in absolute terms people are getting better off at an almost breathtaking speed. There are now more Chinese tourists in Germany than Japanese.
45. **China does not import enough?** This is not true either: in dollar terms, merchandise imports have increased at an average annual rate of 19.7% over the past decade – lately they have been running at a rate of 46.9% y/y (Nov '09 to Aug '10) . Since the trade surplus is relatively stable at about 5 to 8% of GDP, Chinese exports are expanding at roughly the same rate as imports. **The country may be swamping the world with its products, but the world is doing the same to China.** So I do not see the point why such an extraordinarily successful growth model should be given up by adopting a freely floating exchange rate or a big one-time revaluation of the renminbi against the dollar.
46. The Chinese government has **made some small concessions on the exchange rate front because they are afraid of a trade war with the US.** As time goes by, the relative importance of America as a trading partner is bound to shrink. In August, exports to the US were just 19.9% of total goods exports and less than half of the exports to the rest of Asia. It is understandable that China will drag its feet on the exchange rate issue. On the other hand, the US cannot launch an all-out trade war with China because too much is at stake in terms of access to the world's most promising and soon most important market.

47. China will continue to grow briskly. **Old-fashioned Keynesian recipes are still effective** for two main reasons: government debt as well as private sector debt is relatively small which means deleveraging is not an issue, and there is not much risk that expansionary policies will cause an unacceptable acceleration of inflation (CPI is presently 3.5% y/y).
48. For an emerging economy where wages in the tradables sector rise at double digit rates on the back of big improvements of labor productivity, this is surprisingly low – most analysts predict that inflation rates are actually close to their peak. All this mean that **the central bank will maintain its expansionary stance**, with money market rates a fraction of the growth rate of nominal GDP (the relevant benchmark) and money supply in the range of 20% y/y. A high rate of employment growth is the ultimate goal of the Communist party leadership. Social cohesion and political stability are best assured by a quickly rising standard of living. An uneven income distribution is regarded as an acceptable negative side effect of the Chinese growth model, at least for the time being.

robust global growth, some deflation risks, well-supported commodities

49. To sum up, in spite of the problems in countries which are struggling with the aftereffects of earlier borrowing binges, the global economy is moving ahead briskly. **The IMF has just said that the world's real GDP will be 4.8% higher than last year, followed by a growth rate of 4.2% in 2011.** This is in purchasing power terms – expressed in terms of market exchange rates, the numbers are about one percentage points lower (because the dynamic emerging economies get a smaller weight that way).
50. **Global manpower reserves are still huge and will thus prevent a pick-up of inflation.** Deleveraging countries, especially the US, are still exposed to the risk of deflation. There is surprisingly little that can be done to prevent it. Weakening the exchange rate is one remaining tool, but using it unilaterally could easily result in a costly foreign exchange war. The dollar will remain under pressure.
51. There is thus no convincing reason why economic policies should be tightened. The main exception is fiscal policies in those countries which are aggressively trying to bring down budget deficits in order to preserve their credit ratings.
52. **For commodity producers, though not for commodity consumers, the outlook is therefore quite positive.** Strong global growth with a focus on emerging economies and thus on goods production rather than services keeps raising the demand for energy and other commodities. Compared to what we have seen in the first half of 2008 their prices are not yet excessive, and the negative terms-of-trade effects in importing countries look manageable so far, as output growth in this part of the world is fairly resilient by now.

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