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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

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1. **The flight to safety will come to an end this year. Investors should begin to unwind trades that have been driven by the fear that the euro will break up.** My assumption is that the euro crisis will be resolved – giving up the project is economically and politically much costlier than stabilizing the banking sector, supporting sovereign borrowers in the periphery and giving up some elements of national sovereignty. First steps were taken last week in Brussels. A banking union will come before a fiscal and political union.

2. Near-term the ECB will provide all the liquidity that is needed at very generous terms. Before year-end, a "**single supervisory mechanism (will be) established, involving the ECB,** (that has) the possibility to recapitalize banks directly." This task will be assumed by the European Stability Mechanism (ESM). The potential firepower of the two central euro area institutions is considerable. Participants in the Brussels crisis summit had been aware that time was running out and that everyone had to make compromises. The banking sector will no longer be able to wreak havoc, and Greece is getting easier terms.

3. For investors, another key theme is the deceleration of the world economy. The euro area is in recession, but growth in the US, China, Japan, the UK and various net exporters of commodities is slowing as well recently. Output gaps are on the rise, and deflation is therefore a likelier prospect than inflation. But the likely resolution of the euro crisis will prevent that things get out of hand.

how to correct the euro's birth defects

4. By now it is consensus among euro area policy makers that the currency union in its present form has **a serious birth defect – the "inherent contradiction between pan-European banking and exclusive national responsibility for bank crisis resolution**" (Jean Pisani-Ferry et al: What Kind of European Banking Union? Bruegel, June 25, 2012; p. 2). While price stability has been at the center of attention before and the first ten years after the establishment of the currency union, issues of financial stability - such as who would be the lender of last resort, how to prevent bank runs, or how to avoid a renationalization of banking markets - were simply not addressed.

5. European policy makers must soon come up with a credible road map. Markets are forcing their hand. The Brussels agreements have been an important breakthrough, but only a first step. **Even at the short end of the yield curve interest rates that sovereigns in "peripheral" countries must pay are still at levels that are not sustainable, especially in**

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the present recessionary environment. While German government bond yields are at 0.19 per cent in the 3-year range, Spanish and Italian bonds have arrived at 5.01 and 4.36 per cent – before the Brussels summit they had actually been about 60 basis points higher. These two big euro area member countries would be on the way to insolvency if things had been allowed to drift. The conclusion is that the euro cannot survive without significant institutional changes – but it also needs massive financial support in the coming days and weeks.

6. As the authors of the Bruegel paper point out, **recent developments in the euro area have undermined the foundations of monetary union:**

    a. capital is no longer flowing freely from North to South as national governments, under pressure from taxpayers, are encouraging banks to reduce cross-border lending; the interbank market has become dysfunctional, forcing the ECB to step in as financial intermediary; in the process it is accumulating a huge exposure vis-à-vis weak borrowers;
    b. "sovereign solvency concerns have affected banks and bank solvency concerns have affected sovereigns" (idem, p. 2) which creates a vicious circle which the ECB cannot stop; for good reasons, the central bank has no mandate to deal with solvency concerns; country risk is back in EMU;
    c. for taxpayers, the fragmented and uncoordinated approach to banking policy, including ring-fencing and risk-shifting, increases the overall cost of crisis resolution.

7. More of the same is not an option when panic rules. The medium-term solution, as it has been presented to euro area policy makers by heavyweights van Rompuy, Barroso, Draghi and Juncker, aims to stop the euro's race to the cliff and to prevent future banking crises ("**Towards a Genuine Economic and Monetary Union**", European Council, 26 June 2012). It rests on four pillars:

    a. an integrated financial framework, a "banking union" for short, that includes centralized bank supervision and common mechanisms to resolve banks and guarantee customer deposits;
    b. an integrated budgetary framework encompassing joint decision-making, greater enforcement and steps towards common debt issuance – the eurobonds detested by Germany;
    c. an integrated economic policy framework, also known as the growth pact that is strongly promoted by the new French president;
    d. ensuring the democratic legitimacy and accountability of decision-making within the EMU.

8. The least controversial of the four is pillar number 1. **Area-wide bank supervisory powers can and will be conferred to the ECB on the basis of Article 127 (6) of the European Treaty**, a move that makes sense because the central bank is better informed about the health of the banks than any other institution. It was decided on June 29 that the ESM may recapitalize banks directly once such a single supervisory mechanism has been established.

9. **More controversial but indispensable for the stabilization of the euro area banking sector and thus for government debt are a common deposit insurance scheme and a single resolution fund.** There is an agreement, as far as I can see, that these can and should

be implemented as soon as possible. Deposit insurance is needed to counter the threat of bank runs while a bank resolution fund must have the power to close down, shrink and re-privatize banks, shift non-performing assets to bad banks and thus create the conditions for a fresh start.

10. The decades-long problem of Japanese banks is that there has never been a genuine resolution process. Bad loans are being rolled over at interest rates close to zero. In 1990–1992 Sweden, and recently the US, have rather successfully shown how banking crises can be overcome: the **key element is to relieve the banking industry of worthless assets**. Even though this is extremely expensive from a taxpayer point of view, there is no alternative lest the financial crisis drags on forever.

11. **The insurance and resolution funds have to be set up under the control of a common authority, equipped with a solid financial backstop. This will be the ESM; it is guaranteed by the 17 member countries** but has limited resources. During a transitory period the ECB could provide the necessary funding. This is clearly undesirable in the longer term: the ECB should not be burdened with too many tasks. It would be exposed to numerous conflicts of interest, and lose its independence and effectiveness.

ECB will become even more expansionary

12. I expect that the ECB will soon lower the deposit rate from presently 0.25 per cent to zero. Not only that, it may think about introducing a negative rate to stimulate bank lending and thus economic activity. The main refinancing rate may also be cut, from 1 per cent to 0.5, perhaps already at the meeting on July 5.

13. Since the transmission mechanism between monetary policy and the real economy is broken, as households, business and governments are preoccupied with debt reduction and balance sheet repair, additional monetary stimulus is not game changing. The ECB is already very expansionary. **Down the road may lie the risk of new asset bubbles, but for now the main asset markets, in Europe and elsewhere, are moving in the opposite direction, towards asset deflation and debt inflation.**

14. **Buying Spanish and Italian government bonds in secondary and even in new-issue markets by the ECB is advocated by Mediterranean countries as an important element in ending the financial crisis in the euro area. Experience argues against such a strategy.** Bond yields are driven by expectations about inflation and the ability of borrowers to service their debt, i.e. changes in their ratings. None of the two variables will be affected by a bond buying program. On the other hand, there is a downside to such a policy: since bond purchases would supposedly be unconditional, the quality of assets held by the ECB would deteriorate. The ECB cannot enforce conditionality. Neither the ECB nor the Germans like this idea.

15. **Mutualization of euro area government debt** could reduce Italian and Spanish bond yields to manageable levels, because the aggregated budget deficits and debt levels of EMU are moderate compared to those of the US, Japan and the UK. This would end the euro crisis at one stroke. The topic is a taboo as debtor countries remain unwilling to let others decide how large their annual deficits can be. So far they refuse to accept the consequences of not sticking to their commitments. But why transfer German taxpayer money into black holes? As Americans argued at the outbreak of their revolution:” no taxation without

representation**". In reality, though, debt mutualization is actually under way already.** The previous bond buying programs of the ECB and the refinancing operations where low-quality securities are accepted as collateral have been steps in this direction. More is to come.

German proposal of a debt redemption pact: could be a large step towards fiscal union

16. The Debt Redemption Pact that Germany's Council of Economic Advisers had proposed last November has recently been dug out and will get another look (for details see Jahresgutachten 2011/12, p. 109 – 118). It is an **alternative to increasing the volume of the EFSF and the ESM – which is politically difficult** - and less pro-cyclical than the present provisions of the Stability and Growth Pact. Its role model is Alexander Hamilton's 1790 post-revolution restructuring of US government debt.

17. The plan is to **pool all government debt that exceeds the 60 percent of GDP limit of the Maastricht Treaty in a new redemption fund in the order of €2.5 trillion**. Debtor countries would have 20 to 25 years to amortize this part of their debt via dedicated taxes. Over a period of about five years, the roll-over of maturing debt and the financing of budget deficits can be covered by each country's share in the redemption fund, up to the pre-determined limit. Italy has the largest share (€958bn), followed by Germany (580), France (498), Belgium (136) and Spain (88). After this "roll-in phase", a country's debt consists of two parts: those 60 per cent of GDP for which it is fully and exclusively liable, and that part of the debt which exceeds 60 per cent at the time of the fund's launch. It has to be amortized by the debtor government as well, but in case this is not possible, the guarantee of the entire fund kicks in. This is mutualization.

18. **For the German professors on the Council, the scheme is only acceptable in combination with strict and enforceable fiscal discipline** such as constitutional debt limits, a mutually agreed medium-term consolidation and growth strategy, and a possibility to stop guaranteeing a country's debt if it does not adhere to its consolidation commitments. To limit the risks of the potential creditors, countries would have to deposit collateral in the form of currency reserves, gold and other assets. Ireland, Greece and Portugal are not part of the plan because they have their own adjustment programs.

19. **One immediate effect of such a strategy would be that interest rates on newly issued debt (and existing debt as well) would probably fall to the level at which the EFSF is presently borrowing.** In the 10-year range the fund pays 2.69 per cent, compared to Germany's 1.54 and Italy's and Spain's 5.76 and 6.25 per cent. Getting long-term interest rates of member states down to 2.69 per cent would go a long way towards a comprehensive solution of the euro area's sovereign debt problems. Differences in country risk would gradually disappear again and bring the euro area closer to a fiscal union. In the long run, it is not possible to have a monetary union without a mutual control of budget deficits.

20. **The lower interest burden would also enable governments in the periphery to provide more fiscal support for their economies.** Germany and other potential creditor countries can expect rising rates, though, which would restrict their fiscal room for manoeuver. Since the flight into the "German euro" has reduced, and continues to reduce the country's debt service by tens of billions of euros annually, this is more or less a return to a more normal state of affairs. On balance, the Council's proposal calls for more austerity, especially in Italy.

To avoid this effect, policy makers should consider to extend the amortization phase to perhaps 50 years, or partly switch to consols, i.e. securities that never mature. Some debt forgiveness, combined with enforceable budget discipline, must also be part of any future rescue package.

bleak outlook for the economies of the euro area, the US and Japan

21. Near-term euro area fiscal policies are very restrictive in any case and contribute to the present recession. While the output gap is getting wider and unemployment is rising, aggregated **government spending reduces real GDP growth by at least a percentage point this year and thus more than fully accounts for the expected year-on-year decline of GDP by 0.6 per cent in 2012.** Next year growth will again be quite anemic (+0.4% y/y). The general government budget balance will probably decline from -3.7 per cent of euro area GDP in 2012 to -3.1 per cent next year. The average unemployment rate will be no less than 11.2 per cent this year, a full percentage point higher than in 2011. So far, austerity rules in euroland.

22. **Growth in the US is presently in the order of 2 per cent.** While this is considerably better than the performance of the European economy, it is less than the trend rate of potential output which is estimated to be around 2¾ per cent. Employment expands at a much slower rate than in any post-war economic recovery and remains far below pre-crisis levels. Getting back to normal is extremely difficult in the aftermath of a severe financial crisis. America's fiscal policies are quite restrictive, if not quite so much as in the euro area, but capital spending and, to a lesser extent, household consumption are fairly buoyant. Foreign trade has a neutral impact.

23. **It is not intuitively obvious to me why the US is doing so much better than euroland.** In the first quarter of 2012, American (non-farm payroll) employment was 3.6 per cent lower than four years ago, compared to -2.8 per cent in the currency union. So the fact that American consumers are much more confident then European consumers has little to do with the situation on the labor market. It must be perceptions of coming structural changes and expectations that austerity will prevail for years to come that makes Europeans so cautious. Moreover, the recent oil price decline is boosting American purchasing power more than in Europe – thanks to the euro depreciation and lower gasoline taxes in the US. The other reason is that the US banking sector is much better off than euroland's.

24. **Japan has also been slowing recently after the post-earthquake and nuclear catastrophe reconstruction lift has faded.** Real GDP this summer seems to grow at an annualized rate of only 1¼ per cent after about 2½ per cent during the winter quarters. The strong yen and the cooling of the world economy are leaving their marks, not least in the balance of trade which has been in the red 15 months in a row now. The balance on current account is still in surplus (1.7 per cent of GDP), thanks to the substantial income from accumulated foreign assets. Note that the unemployment rate is only 4.4 per cent and that CPI has probably been 0 per cent y/y in June. While the government budget deficit will be no less than 8 per cent of GDP this year, and gross government debt something like 250 per cent of GDP, the yield on 10-year government bonds is just 0.82 per cent. How come? Japan is a major net creditor to the outside word.

emerging markets are also losing momentum

25. Emerging markets remain the drivers of the world economy, but have recently lost considerable momentum, especially because **China's $7,800bn economy suffers from weaker exports and construction activity.** Rather than growing at the usual rates of 9 to 10 per cent a year, real GDP is advancing "only" at a rate of a little less than 7 per cent - this feels like a recession. The transition from exports and investment demand to consumer demand is not smooth. Policy makers have several bullets left in their arsenal, though. Since inflation is low – in May, CPI was 3.0% y/y, PPI -1.4% y/y – they can afford to stimulate the economy. Aggregated government accounts, including $3.4tr of currency reserves, are still quite sound. Most analysts assume that stimulus measures will work. But if there has been debt-fueled overinvestment in property and infrastructure that now requires deleveraging, they may not. Hard to say. Leading indicators suggests that the loss of momentum is still ongoing. The slight depreciation of the renminbi against the dollar over the course of this year – from 6.30 to 6.35 – is a sign how worried the Chinese leadership is about the health of the economy.

26. **Russia, the main commodity producer and exporter, with a $1,700bn economy, has so far benefited from the recent commodity boom.** Real GDP was up 4.9 per cent year-on-year in Q1. Disposable incomes have actually increased by about twice that rate thanks to very favorable terms of trade which in turn were driven by rising prices of raw materials, a strong rouble and stable euro import prices. This has not only boosted household incomes and business profits but also government revenues. Overall demand has been very strong. Meanwhile inflation rates continued to come down, to the surprise of Russian analysts who think a 6 per cent inflation rate is sort of normal, reflecting the decline, in rouble terms, of import prices and the still-significant output gap.

27. **In the wake of the 20 to 30 per cent decline of (dollar) commodity prices since the middle of March, the rouble has depreciated, stock markets have tumbled and disposable incomes have been hit.** It is not a free fall like in the second half of 2008, mostly because it was not preceded by a long period of exuberance. In addition, the point from where the fall began had been lower. The likely survival of the euro has also been a benefit for commodity markets and thus for Russia. Stocks remain very cheap in terms of price to book ratios, risk premia and future GDP growth rates in the order of 3.8 per cent – lots of bad news has been priced in. It is a great market for contrarians.

28. In purchasing power parity terms, **emerging economies account for one half of global output. Their real GDP is presently expanding at an annualized rate of about 4 per cent, or by fully two percentage points below trend.** Output gaps are therefore widening which keeps a lid on inflation and enables governments and central banks to pursue expansionary policies. Their financials are mostly sound, including high savings rates, which provides a solid support of their economic catching-up processes. I expect a re-acceleration of growth in the second half of this year already. The emerging world is the place to be.

29. **World real GDP growth is actually in the 1½ to 2 per cent range. It will remain sub-par well into 2013.** The main drag is the decline of output in the euro area and the UK. Since output gaps have widened on a global scale, consumer price inflation is at an unusually low 3 per cent y/y. I do not see any acceleration over the next twelve months – a deceleration is more likely.

spread trades in bonds, long equities, short commodities, short the dollar

30. **In general, bond markets are thus well supported. The distortions which had been caused by the euro scare will disappear, perhaps faster than most investors would expect.** One has to keep in mind that a "normal" yield of longer-term high-grade government bonds is the product of productivity growth, expected inflation plus a risk premium reflecting the higher volatility at the outer end of the yield curve and liquidity differentials. For a country like Germany this translates into 1.2 times 1.8 times 0.5 per cent, i.e. 3.5 per cent. As the yield discount for the safe haven status disappears, the yield of 10-year bunds will rise towards this level. French yields will also rise, if by less. Italian and Spanish yields will fall. All this is under the assumption that the euro will survive on the basis of a resilient institutional structure and some degree of solidarity among member states.

31. This assumption also suggests that **Swiss franc, US dollar and yen bond markets will lose some of their attraction and should be used for shorts in spread trades.**

32. Incidentally, the same formula applied to an **emerging economy produces a "normal" long-term government yield of 10 per cent**, the product of 4 per cent productivity growth, 4 per cent trend inflation and 2 per cent for volatility and liquidity risk.

33. Another implication of the end-of-the-euro play is that **high-dividend stocks of companies with a solid market position are preferable to today's safe haven bonds.** The income distribution will continue to move in favor of capital and profits, at the expense of labor income. This follows from the relentless integration of the world's markets for goods and, increasingly, services. Wage increases in rich countries are determined by marginal but comparably qualified workers in China and Mexico – and have only modest upside potential as long as free trade is permitted. For decades, the volume of international trade has been expanding almost two times faster than global GDP. Small, medium and large companies are all becoming multinationals, with a wide range of potential production sites. Rich country wages are under pressure, profits are not, and equities of rich country companies are better than bonds.

34. Because global growth is so subdued **commodity prices have probably not yet bottomed out.** The dollar price of oil is still well above its 10-year average of $72. So this is not a particularly daring statement. I guess that commodity prices have covered half the distance between their March high and their low later this year. They have rebounded nicely over the weekend, compliments to Angela Merkel, but in view of the fundamental forces at work, this will be just a brief respite.

35. **Exchange rates have also been distorted by the euro scare.** Depending on how quickly the euro safety net will be put into place, I would expect a rebound of the euro: the aggregated balance on current account of the currency union will show a small surplus this year, the aggregated government budget deficit will be in the order of 3.6 per cent this year and an impressive 3 per cent next while consumer price inflation will average 2 per cent, a little higher than in the US. **I expect that the euro will be trading at $1.38 at the end of this year.**