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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

by Dieter Wermuth*

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1. Most major economies are slowing, downside risks abound, yet stock markets are holding up well, and the oil price remains above $110. How can that be**? I think we are witnessing a general shift from expensive high grade government bonds to stocks that generate attractive dividends.** Corporate bonds, including junk bonds, have also been in strong demand. While this is plausible, the resilience of the oil price is hard to explain in economic terms.

2. **Doubts about the future of the euro and the risk of sovereign defaults are the main reasons for the ongoing flight to safety.** Many investors seem to prepare for a catastrophic escalation of the euro crisis. Developments in the currency union are coming to a head this fall, and policy makers can no longer postpone game-changing decisions.

3. These are now forthcoming: after the June 29 decisions about creating a banking union this year already, recent statements by ECB President Draghi and Ms. Merkel's apparent new willingness to lead from the front, it has become **likely that there will be a comprehensive solution**. For one, the fatal link between banking problems and sovereign borrowers will be cut. In addition, governments that have applied for assistance from the EFSF/ESM, the euro area's present and future bail-out funds, will get access to more or less unlimited funding at manageable rates, provided they stick to their commitments (what if they don't?).

4. The ECB, with its control of the printing press, will be the main actor, rather than the tax payers - who would go on strike if they had to come up with further and ever larger guarantees for struggling Mediterranean borrowers. **There is a bail-out fatigue in the creditor countries of the North which explains why politicians have warmed to the idea of giving a key role to the ECB.**

5. **For investors, the approaching end of the euro crisis implies a major reshuffling of assets.**

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* Dieter Wermuth works as a consultant for Wermuth Asset Management GmbH and regularly contributes texts to the HERDENTRIEB weblog which is available on the ZEIT online website.

the world economy is slowing

6. The amount of slack in the world economy has been rising again this year. At market exchange rates, the trend growth rate of global real GDP had been 3.0 per cent in the 15 years through 2008, but GDP is presently expanding at a rate of only 2 per cent; actual global output is 6 per cent or more below its trend line. Unemployment remains very high, especially in the euro area and the English speaking countries. The recovery from the 2008/2009 global recession which had been anemic in the first place, is stalling. Barring a major political shock, such as a wider war in the Near East, **disinflation is therefore more likely than a return of an inflationary spiral.**

7. **Emerging markets as a group continue to outgrow developed markets by a wide margin.** The reduction of their real GDP growth rate to 4½ per cent in the two summer quarters may be disappointing for people who have come to regard annual rates of more than 6 per cent as normal, yet compares very favorably with the OECD Q1 and Q2 growth rate of just 0.6 per cent. Most of the emerging economies are quite sound financially while living standards are still very low. They can therefore be expected to **remain the world economy's driving force for decades to come. Assets which benefit from these catching-up processes are indispensable components of any portfolio with a focus on the long-term.**

8. **As to the near future, most analysts expect stronger growth from now on.** This is not supported by leading indicators other than stock markets – and these are notoriously bad in predicting the future. But it is also well-known that a turnaround of the economy is often already under way when the incoming statistics and the mood of consumers and entrepreneurs still point in the other direction. When inventories have been depleted in response to weak final demand, when firms have cut back on capital expenditures for an extended period of time and have accumulated piles of cash instead, when central banks have pulled out all stops to stimulate lending and spending – then it may just happen that those fabled **animal spirits** suddenly revive, and the recovery begins.

towards a comprehensive solution of the euro crisis

9. The trigger this time could be the upcoming series of decisions by euro area politicians, including the ECB, to stabilize the euro. After they have repeatedly proclaimed that they would do whatever it takes they are now forced to act. The **economy is in very bad shape, with real GDP in 2012 expected to shrink by half a per cent year-on-year, and unemployment of more than 11 per cent.**

10. **Even Germany whose economy seemed unassailable is losing its vigor:** unemployment has increased five months in a row, if only moderately, and remains a low 6.8 per cent, but real orders to the manufacturing industry have declined at an annual rate of no less than 7.7 per cent in July. Orders from the partner countries in the currency union were actually down 19.6 per cent! These data are the most reliable bellwether of things to come. It does not look good.

11. The time has come to provide the currency union with a resilient institutional framework. **This Thursday the ECB will probably announce that it will start buying, probably without a quantitative limit, short-term bonds of governments which have applied for help from the bail-out funds.** For some Germans, including those at the top of the

Bundesbank, a red line will once again be crossed by such “non-conventional” actions: by monetizing government debt the central bank becomes a so-called fiscal agent and thus may lose its independence.

12. Can the ECB really stop purchasing Spanish bonds when Spain’s government one day announces that it is unable to meet the conditions it had itself committed to? It is better to leave such decisions, which can include the impositions of sanctions, to an independent institution such as the **ESM. Giving this bail-out fund a banking license and thus de facto unlimited financial firepower** would go a long way to avoid moral hazard at the ECB, a conflict of interest between the goals of price stability and financial stability.

13. Since Europe’s central bank is on the road to rescuing overindebted governments (as a fiscal agent) and is also expected to play central roles in the new supervisory system for banks, in euro area bank resolutions and deposit insurance, it is at risk of being overburdened by too many tasks. This problem needs to be solved. **Remember the Tinbergen rule?** For each and every policy target there must be at least one policy tool. If there are fewer tools than targets then some policy goals will not be achieved. The technocrats at the ECB cannot solve Europe’s problems all by themselves. It can only work in the very short run.

14. **If the euro is to survive there are almost no near-term alternatives to the formula “money printing plus conditionality”.** Large countries such as Italy and Spain are in deep recession, with real GDP presently declining at annualized rates of about 2 ½ per cent and unemployment at 11 and 25 per cent, respectively. At the same time, they are pursuing ambitious but pro-cyclical fiscal policies and structural reforms. Greece, Ireland, Portugal, Cyprus and Slovenia are trying the same. They are all flirting with disaster. Temporary debt relief is inevitable.

15. In the 3-year range, Germany’s government can borrow at -0.02% while Italy’s has to pay 3.62%, and Spain’s no less than 4.46%. For Italy and Spain such rates are much too high: their deep recessions lead to a decline of tax revenues and rising expenditures for unemployment benefits. High borrowing costs are an additional burden which increase budget deficits and make it so much harder to reduce them. At longer maturities, rates are even more deadly. They would lead directly to sovereign defaults and thus most likely to the blow-up of the euro.

16. **If governments would borrow from the EFSF or its successor, the ESM, they would have to pay much less, for 5-year notes perhaps something in the order of 1½%.** Inflation-adjusted this would be a negative interest rate. The benefit of a significantly lighter debt service burden will dampen the pro-cyclicality of fiscal policies and thus stimulate growth. To avoid moral hazard and allay the fears of German and other taxpayers, borrowers must accept the strings attached to such help - and be on their own again if they start to play games, like asking for more time.

17. As it looks, secondary market purchases of short-term bonds are possible under the ECB’s mandate. To avoid an excessive lengthening of the Eurosystem’s balance sheet, the board may, but does not necessarily need to consider reducing the volume of “normal” money market operations. In general, the **inflation risk of creating yet more central bank money is small at this point: the transmission mechanism that links it with M3 and bank lending remains broken.** The volume of M3 was only +3.8% y/y in July, still below target, while credit to euro area residents was just +1.2% (and -0.6% y/y to non-government).

18. **Debt reduction, or deleveraging, remains a priority in much of the euro area's public and private sectors.** Even record-low interest rates do not have much of an impact on spending in such an environment. Core consumer price inflation has lately been 1.7% year-on-year while hourly wages, the other important predictor of future inflation, were 1.9% y/y. Expansionary monetary policy is less dangerous than under normal circumstances.

19. **On September 12, the German constitutional court hands down its ruling about the legality of the ESM.** This is another important event on the road to a more stable euro. The Stability Mechanism implies that national parliaments have to give up control over a potentially very large chunk of tax payer money. Decisions are made by the ESM where they do not have a veto. The court is usually very concerned about preserving the national sovereignty and may not like what it sees. On the other hand, the preamble of the Basic Law, the country's constitution, states that the German "people are inspired by the will to serve on an equal footing in a united Europe". Why had it been constitutionally ok to give up the Deutsche Mark and create a currency union but declare as unconstitutional attempts that aim to preserve it? I don't think the court will block the ESM.

20. **All of the above means that the euro will probably survive. It is also likely that Greece will stay,** even though the debt relief must go beyond paying lower interest rates, such as an interest-only period of several years. This will be much cheaper for holders of Greek assets than a sovereign default and is therefore relatively attractive. I hope I am not too naive. A further escalation of the crisis – such as a full-blown bank run – may be needed to force the hand of policy makers. But the situation is already quite serious as it is.

saving the euro leads to changes in portfolio composition

21. As soon as the planned institutional reforms of the euro area can be taken for granted, investors will start to **bet on an appreciating euro, a reduction of yield spreads between bonds of core countries and countries in the periphery, lower risk premia on euro area stocks which are driven by domestic demand, and an end of the euro area recession. The world will look different.**

22. Since the euro exchange rate will strengthen, stocks of firms that export to non-euro area countries will do less well in relative terms than domestic stocks. In general, capital spending would become more attractive again as the growth outlook improves. Stock markets of countries which rely heavily on demand from the euro area will rebound, including Britain and the countries to the East, such as Poland, Hungary and the Czech Republic.

23. **The oil price will benefit from the better economic prospects of the euro area and the surrounding countries which together account for about 20 per cent of global GDP** – on the other hand, commodities such as oil lose some of their appeal as safe haven assets. Armageddon, following a series of sovereign defaults in the euro area and its Eastern neighborhood, will not happen. On balance, a crash of commodity prices has therefore become less likely. One corollary of this is that the required risk premia in the stock markets of commodity producing countries such as Russia, South Africa and Australia will be lower, boosting their indices.

US economy fails to gain momentum

24. Going forward, **US growth remains a key determinant for the rest of the world economy**, as well as for most asset markets. After four years of $1tr government deficits, near-zero policy rates and a huge increase of the Fed balance sheet, real GDP growth is actually slowing to well below par. So far this year, the annualized growth rate has been less than 2 per cent, including 1.5 per cent in the present quarter (J.P.Morgan estimate). At comparable stages of earlier business cycles growth rates used to be 5 per cent or more.

25. US unemployment is stuck at more than 8 per cent. Excess labor supply has caused a five per cent decline of median real incomes over the past three years. **Output is not only far below potential**, and potential itself seems to be growing much less than in the past, due to the withering of the housing and financial sectors. There is, of course, one **positive aspect: headline consumer price inflation is just 1.3% y/y**. No one seems to be really happy about this "success" – it simply reflects the weakness of demand.

26. What is happening? The best explanation I can offer is the **destruction of household wealth** which, according to the Fed, has been no less than 39 per cent between 2007 and 2010 (on the basis of the median). Large debt-fuelled asset price bubbles have popped. Frugality, called deleveraging, is now the fashion of the day. Following such a wealth shock, the return to "normal" takes considerably longer than after a standard recession, as Reinhart and Rogoff have shown in their seminal book on eight centuries of financial folly ("This time is different"). Between early 1999 and late 2008, outstanding household debt has increased from $4.6tr to $12.7tr, and has since shrunk to $11.4tr - which is thus still 150 per cent more than 13 years ago. It will take a while before households are in good financial health again. The US is following the Japanese path after all.

27. **A new major risk is the so-called fiscal cliff**, the risk that the automatic expiration of the Bush tax cuts and various spending programs at the end of 2012 will lead to a massive reduction in the budget deficit and a corresponding slowing of the economy. Since Congress is in a confrontational mood, there are no signs yet that there could be some compensating relief. In my experience, however, it is likely that sometime after the election a last-minute solution will be found, and catastrophe will not happen. It is relatively easier to reduce taxes and increase spending than the opposite, even for Republicans.

28. Since it is consensus among analysts that US economic growth will remain in the order of a disappointing 2 per cent per year for the foreseeable future, it is **surprising that America's stock markets are doing so well**: the S&P 500 is up almost 12 per cent year-to-date, and NASDAQ almost 18 per cent, with (trailing) price-to-earnings ratios of 14.3 and 16.5. A simple explanation could be that business (along with government) benefits of those extremely low interest rates. As the main borrowers, firms are gaining what households - which are net savers - are losing. The cost of outside funds, and thus of capital, has fallen dramatically.

29. At the same time, the **deleveraging process in the household sector keeps a lid on consumer spending which in turn suggests that domestic demand is bound to stay weak.** Low interest rates may actually force people who want to create a nest egg for retirement to save even more, and spend less than they had initially intended. So capital outlays by business tend to relatively small in such an environment. As a result, firms are cash rich and in unusually good shape financially. For investors they are increasingly a better risk than

sovereign borrowers. The average dividend yield of the S&P 500 of 2.1% is well above Treasuries' 10-year yield of 1.55%.

30. Incidentally, **the same argument can be used to explain the resilience of euro area stock markets**: in spite of the recession, the EURO STOXX 50 is up 7 per cent since the beginning of the year, trades at a trailing p/e ratio of 20.9 (!) and has a very attractive dividend yield of 4.3%. On the basis of expected 2012 earnings, the p/e ratio is a more reasonable 10.4, though. It shows that corporate earnings are on the mend.

31. Back to the US: another **one of this year's surprises has been the fact that the dollar has not been stronger against the euro**, considering that the expected difference in 2012 real GDP growth rates between the US and the euro area is in the order of 2½ per cent. What happened to all those predictions of an imminent demise of the euro? Market participants had obviously a different view than analysts. From its high of $1.35 in late February, the euro has only declined to $1.26 today. If my view about the survival of the euro proves to be broadly correct, the expectation of an acceleration of euro area growth, the region's current account surplus, and an aggregated 2012 budget deficit of 3.4 per cent of GDP (the US deficit is at 7.6% of GDP) will probably lead to a depreciation of the dollar against the euro. My prediction that the euro will cost $1.38 at year-end, made in the July Investment Outlook, still stands.

Asia still strong, but also slowing

32. **China has been the main engine of global growth for at least the last decade. Its economy is now slowing. Annualized, real GDP expanded at less than 7 per cent** in the first half of the year, compared to the customary rates of about 10 per cent. Industrial production was up 9.2 per cent year-on-year in July, a long shot from the standard 15 to 20 per cent rates. Total industrial profits fell 2.7 per cent from last year in the first seven months of 2012. To be sure, the economy is still very robust, but the problems in exports and residential construction are showing. The shift to new sources of demand is accompanied by a loss of overall momentum.

33. **Attempts to stimulate output are under way since last November but it will take several quarters before the results will show up in the statistics**: the emphasis is on infrastructure projects once again. The time lag between initial decisions and the breaking of the ground is long. In May, sales of construction equipment were still 20 per cent less than one year ago. Another reason is that the stimulus is much weaker than in 2008 when excess lending led to waste and financial risks, a mistake the authorities do not want to repeat. Finally, since there is obviously a lot of overcapacity, including in real estate, the private sector's incentive to invest is not really strong.

34. **On the other hand, stimulus measures will be more effective than in many other countries because China has no problems with the after-effects of burst asset price bubbles**. At the same time, the budget deficit is small, the current account surplus is the world's largest (if Germany, as a member of the euro area, is excluded), the renminbi does not appreciate against the dollar any more, and currency reserves are in the order of $3½ tr. It can be expected that GDP growth will indeed begin to pick up, perhaps to about 8½% annualized between now and the end of 2013. China will reassert its role as driver of the world economy. This is good news for the producers of commodities and capital goods in the rest of the world.

35. **Japan, the other big Asian economy, has decidedly weakened in recent weeks.** It looks that real GDP will more or less stagnate in the second half of 2012. Industrial production fell 7.7 percent annualized in Q2, and could well decline at a rate of 12 per cent in Q3. This reflects the strength of the yen, the intensifying competition among Asian capital and consumer goods producers, the cooling of growth in China and unexpectedly large inventories.

36. The Japanese government has precious little room for stimulating policies at this point: the general government budget deficit will hit 9½ per cent of GDP this year while the Bank of Japan has yet to consider even more non-conventional measures. As it is, the country will be a drag on the world economy.

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