WEBLOG

Wermuth's

Investment Outlook

October 2012

ZEIT online • HERDENTRIEB

blog.zeit.de/herdentrieb/

Wermuth's Investment Outlook

by Dieter Wermuth*

October 8, 2012

main underlying trends in developed economies

1. **For years to come, the economies of most OECD countries will expand only slowly**, perhaps by one full percentage point per year less than before the financial crisis. This year's and next year's rate of growth of real GDP will be in the order of 1 ¼ per cent, just as in 2011. The US is doing better than the average, mostly because of the quick resolution of its banking problems. America's new standard growth rate seems to be 2 per cent - this is also well below the rates that had been considered to be normal not long ago. The euro area and the UK are in outright recession while Japan is about to enter one, now that the post-Fukushima reconstruction effects are running out.

2. That growth is not stronger, more than five years after the implosion of interbank money markets, and four years after the Lehman bankruptcy, has to do with **still-unresolved debt problems**.

3. **Households** in the US, in Japan, in the UK, in Spain, Ireland and several other countries, together accounting for at least one third of the world economy, are financially under water after debt-fuelled property and equity bubbles have popped; they cut down on spending, almost no matter how attractive borrowing conditions have become.

4. **Banks,** under pressure to generate high returns on equity, had loaded up on what later turned out to be dodgy assets, in particular asset backed securities and mortgages on overpriced real estate. When the chicken came home to roost, they were forced into huge write-downs which ate up their slender capital base and brought them to the brink of insolvency. Nearly all major banks had to be closed down, were forced to merge or had to be recapitalized with public money – this includes German and French banks. They also had to improve their capital ratios by shrinking their balance sheets; cutting back on lending was the main strategy.

5. **The rescue of the banks, in turn, drove up government debt** to such levels that fiscal policy makers de facto lost all their room for manoeuver. Even countries where debt was significantly below the Maastricht threshold of 60 per cent of GDP when the crisis broke out – such as Spain, the UK or Ireland – suddenly found that they were over-indebted. Markets forced them to pursue restrictive, indeed pro-cyclical policies.

* 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.

6. **All these closely related developments make it difficult to get back to "normal".** Deleveraging, and debt reduction in general, takes years, because the normal Keynesian recipes are not effective. Debt forgiveness would shorten the process, but lenders are very much opposed. So overall demand for goods and services will remain weak.

7. There is **also a structural problem: in many economies, construction and finance, two sectors which had been major drivers of GDP growth before the crisis, had become much too big** relative to the long-term demand for their products. They are now shrinking to more realistic levels. In the US, at some point last decade, they accounted for about half of all corporate profits, reflecting speculative excesses. Replacing their "output" by some other, equally profitable lines of production, takes time, especially if the exchange rate, for some reason or other, does not depreciate.

8. As it is, **output gaps in the rich countries are still very large. recently they have actually been widening.** One reliable indicator for this is the high rate of unemployment throughout the entire OECD region, another is the fact that real wages are either rising very slowly or continue to shrink. Seen from this fundamental perspective, inflation risks are therefore rather limited. Disinflation will be with us for some more years. Japan is everywhere.

9. Because of the underemployment of resources, **low policy rates and an aggressive flooding of OECD economies with central bank money will not necessarily translate into the desired acceleration of household, business and government spending.** The monetary transmission process is broken, and central banks have become toothless tigers: they are almost unable to stimulate economic growth.

10. **Quantitative easing does not get rid of the debt overhang.** For this, lenders, and savers in general would have to be expropriated in one way or other if the alternative, rapid economic growth, is not available. Savers and lenders are mostly the old and the well-off who together dominate policy making and know how to defend their interests. The traditional way to achieve a reduction of real debt burdens is via inflation, but that road is blocked by deleveraging. At some point, the Fed or the ECB may have to consider penalty rates on bank deposits, ie negative nominal interest rates. Real short term rates are already negative in most developed economies, but more radical measures may be needed to cut the Gordian knot.

11. Since monetary policies are neither effective nor inflationary any longer it is a safe bet that **central banks will continue to provide lots of liquidity at very generous terms**. They are risking little, because they have the tools to absorb any surplus liquidity once inflation threatens to get out of hand: interest rates and the quality requirements for collateral in open market operations can be raised if necessary. It is technically easy to shrink the supply of central bank money, just as it is easier to pull than to push on a string.

12. **In countries with a safe-haven status, such as the US, the UK, Germany, France, Switzerland or Sweden, low nominal policy rates will persist as far as the eye can see.** Long-term government yields will stay low as well, partly for this reason, which makes it difficult for institutional investors such as insurers and pension funds to meet their liabilities. "Riskless" assets are "yieldless" these days. Alternative asset classes need to be explored.

euro will survive

13. One such asset class is **government bonds of countries in the periphery of the euro area**. On October 5, yields in the 10-year range were the following: Greece18.0%, Portugal 8.0%, Spain 5.7%, Italy 5.0%, Ireland 4.8% (while Germany was at no more than 1.5%). These "periphery" bonds are well supported by ultra-loose ECB policies - but buying them is of course less a bet on a continuation of expansionary monetary policies but on the future of the euro. **Will these countries still be members of the euro area next year?**

14. I am convinced that they will, for several reasons. **The euro remains a hugely popular currency,** with approval ratings in the order of 80 per cent. It has made everyday life much easier, especially travelling, cross border transactions and price comparisons. Business generally likes the euro as well. The common currency facilitates long-term planning and the regional diversification of production because one major uncertainty about the future has been removed: intra-European exchange rate fluctuations. Business sees the euro as a catalyst for the creation of a genuine single market, the gradual disappearance of national borders. This leads to economies of scale and therefore lower costs and an improved competitiveness.

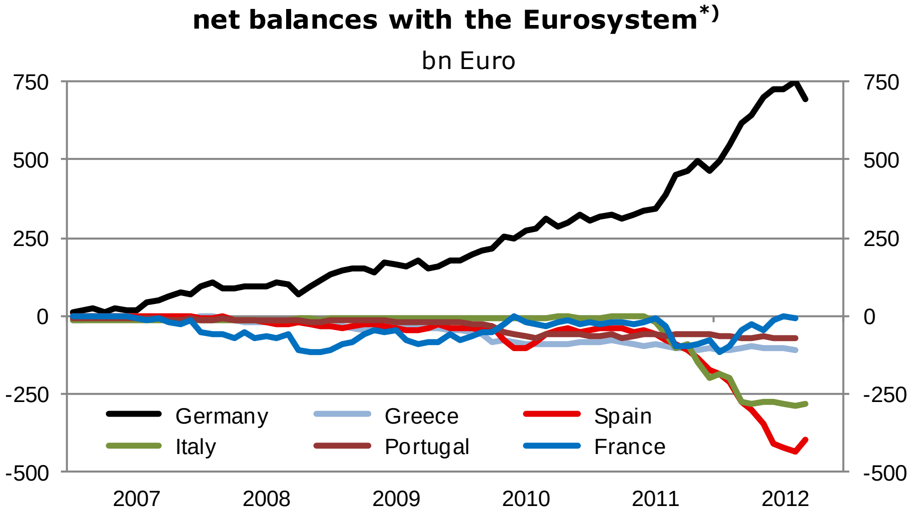
15. In addition, **policy makers have now agreed to create a full-fledged banking union** which aims to cut the dangerous link between bank crises and sovereign debt that has plagued Europe so much during this crisis. The project's deadline "end of 2012" is probably too ambitious, and many late-night battles have yet to be fought, but I think there is a will to compromise, especially when the crisis escalates further which could happen any time because there is so much at stake – national sovereignty and the cost of financial transfers in particular – for each of the participants.

16. **The banking union will consist of three main elements**: central banking supervision, central bank resolution (perhaps only for the systemically important two dozen banks of the area, or for banks which are large relative to the GDP of the country where they are headquartered), plus a common deposit insurance scheme to avoid bank runs (a very real danger). At least **in the beginning, the ECB with its unlimited firepower will play the key role**; over the longer term, issues such as conflicts of interest, concentration of power in one place or independence from fiscal policies have to be addressed.

17. **A final reason why the euro will survive and why not even Greece will leave or get kicked out are the mind-boggling costs of winding it up as well as the unpredictable knock-on and domino effects.** The Lehman crisis would look like a walk in the park in comparison to the shock of a euro collapse.

18. It would be especially expensive for Germany. **The likely appreciation of the amputated euro or a new Deutsche Mark would be the smallest problem**. Switzerland and Japan, but also Germany pre-unification have shown that this can be handled. A stronger exchange rate may actually be beneficial: it promotes structural change in the direction of higher value added production which can be wealth-enhancing if managed well. Things get serious, however, should one or several countries actually declare default.

19. Those who follow German media may get the impression that such defaults may come about because of the large increase of the Target2 balances at the Bundesbank and the central banks of the other "core" countries: Holland, Finland and Luxemburg. This is not so.



*) related to TARGET2 transactions

sources: national central banks

20. **Target 2 is the real-time clearing system of the daily transfers of central bank money among member banks.** The balances reflect part of the net capital movements which are organized via the eurosystem (of central banks). When central bank money is wired from one country to another, the payer's account at his national central bank (such as the Bank of Spain) will show a negative balance while the balance of the receiver's account (for instance at the Bundesbank) will show a same-size surplus.

21. Mostly as **a result of capital flight from the periphery of the euro area** to the perceived safe havens of the core, the aggregated positive and negative balances of the two groups in the eurosystem are now both in the order of €1tr; this is equivalent to about one tenth of the euro area's GDP. Private claims against the periphery have largely been replaced by public sector (ie central bank) claims. France, incidentally, is neither the target nor the source of net capital movements via the eurosystem. Is it core, is it periphery? It is sitting on the fence.

22. Especially German analysts are worried about the sheer size of these balances and the fact that they have been increasing so rapidly since the fall of 2007, with a noticeable acceleration of the process over the past year. Until recently, it almost looked like a bank run. In closed systems like the British or Swiss ones, shifts of deposits from one region to another is inconsequential – no one would even bother to look. It's simply a money-go-round. But if there is the possibility that a region or a whole country – as in the case of the euro – **might declare default and leave the monetary union, the assets of the creditor (countries) would massively lose value**. Their central banks make losses and thus would need to be recapitalized.

23. This is not such a big deal as it may sound. There would only be modest negative effects on tax payers. Since a central bank such as the Bundesbank can create central bank money at will (as long as it remains within its mandate to secure price stability). It would raise its capital internally, so to speak, by inserting an adjustment item on the asset side of its balance sheet, just as Germany's central bank had done after World War II. This item would be exactly as large as the amount of the recapitalization. No need to tap capital markets. **In a Spanish default, for instance, the actual losers would be all those who have financed Spanish borrowing in the past and have thus accumulated claims against Spanish**

residents. These are the households, banks, non-banks and governments in the "core" countries of the North.

24. In other words, the risk is not the size of Target2 balances but a euro exit of countries in the periphery (or of Germany!). Because of the enormous cost of one or several sovereign defaults or exits politicians are forced to prevent this. **The deal will be** that Germany makes financial concessions, ie shoulders more risks and agrees, directly and indirectly, to a further mutualization of euro area sovereign debt, while potential borrowers accept that their fiscal policies are scrutinized and controlled by some central institution. Countries that apply for ESM bail-out funds have to give up some sovereignty in this regard. Such "sacrifices" result in considerably lower borrowing costs.

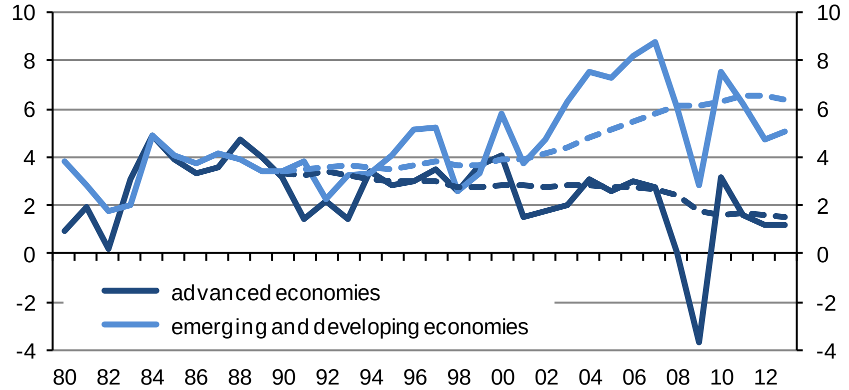
25. If I am right about this, **yield spreads within the euro area will narrow, and the yields of Greece, Portugal, Spain and so on will fall**. In real terms, ie inflation-adjusted, these are very high – because investors are demanding a safety margin for the risk of default. Take this risk away and yields will come down. Inflation is quite moderate in these countries and does not justify those high long-term interest rates.

26. **The decline in yields will happen even though sovereign debt levels will remain very high.** Policies demanded by the ESM, the European Commission and market participants have pro-cyclical effects on revenues and spending. At least in the near term, planned structural reforms will also hurt government finances. For investors, government debt matters less than the prospect that the euro will be put on a stable institutional base, and that leaving the euro will no longer be a realistic option. Japan, and to a lesser extent the US and Britain show that high government debt is compatible with extremely low nominal, and even negative real bond yields. Large budget deficits usually reflect poor economic conditions – which reduce inflation expectations – rather than reckless fiscal policies.

27. One corollary of the above is that **the euro will probably appreciate significantly once it becomes clear that the monetary union will survive.** The euro looks quite sound in terms of important statistics such as the balance on current account with third countries, net foreign assets and the overall fiscal position. With the uncertainty about the future of the currency out of the way, it is also probable that economic growth of the area will accelerate – this will give an additional boost to the exchange rate. On the basis of fundamentals, I think that the euro will gain against dollar and sterling, perhaps against the yen, but probably not against renminbi, Swiss franc and the Scandinavian currencies whose fundamentals are even sounder than those of the euro area.

emerging markets remain the drivers of global growth

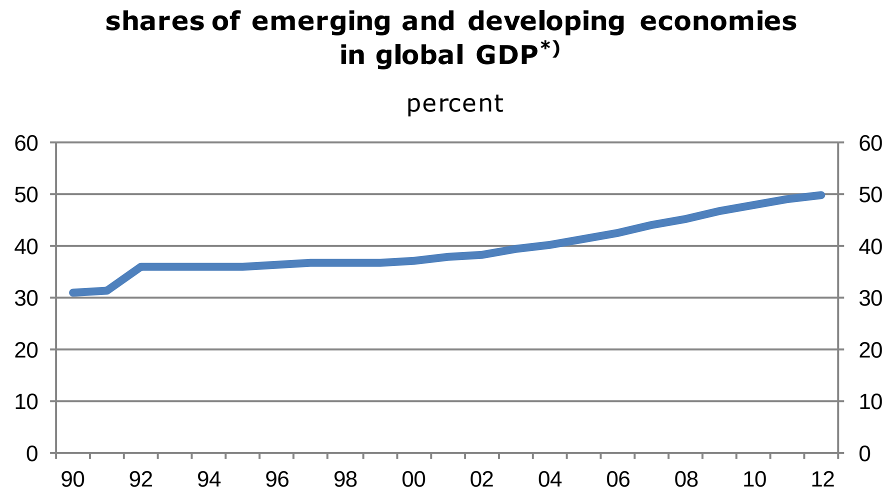
28. **Seen from a macro perspective, asset allocations have to shift further to emerging and developing countries where 85 per cent of the world's population lives.** This is where the growth is. In the last couple of quarters, real GDP of this group of countries has expanded at an annualized rate of 4.6 per cent, compared to 0.7 per cent in the OECD region. This is not a temporary phenomenon: as the graph shows, trend growth rates are also much higher, almost by a factor of three.



*) 2012: estimate, 2013: forecast; dotted lines indicate 10-y moving averages
sources: IMF, JP Morgan, own calcuations

29. **Rapid economic growth looks sustainable** because the key emerging countries are financially very sound: households save a lot, government budget deficits and debt levels are low, many have huge currency reserves relative to the size of their economies, and as a group they are net capital exporters (in an ideal world, they should be net importers!).

30. Since per capita GDP is on average just 18 per cent that of the rich countries, they are obviously still very poor. Given the extremely uneven income distribution, the median income is actually quite a bit below those 18 per cent. But it also means that **the process of catching-up with developed economies has decades to run.** If emerging countries grow 6 per cent a year while the OECD stays at 2 per cent it takes 45 years for average per capita GDP to be the same in the two parts of the world. Don't take that calculation too serious – because of the heroic underlying assumptions – but sometimes it is just too tempting to extrapolate trends.



*) based on PPP; 2012: estimate

source: IMF

31. **The risk is that the flood of liquidity which originates in Europe, the US and Japan leads to asset price bubbles in those poor but rapidly growing countries.** There have been signs of overinvestment in Chinese property and infrastructure recently. When expected

marginal returns fall below the cost of capital spending, asset prices tend to collapse and deleveraging begins - which in turn leads to a so-called demand shock and slower economic growth. China seems to experience a “hard landing”, with annualized real GDP growth presently well below 7 per cent. Something like 10 per cent used to be normal. To be realistic, if this is called a hard landing, Europeans would love to have one as well.

32. **Investors should not worry too much about the fact that inflation in poor countries is quite high, about 4 per cent on average**. It is not a sign that international competitiveness is suffering. Keep in mind that productivity probably increases by 5 per cent annually when real GDP expands by 6 per cent. In such a scenario, unit labor costs, ie productivity-adjusted wages are actually falling, improving competitiveness (under the additional assumption that nominal exchange rates do not appreciate).

33. **Why is productivity growth so rapid in emerging economies?** In general, the application of modern technology and processes in manufacturing, earth moving, transportation, communication, agriculture and so on, plus the creation of a modern infrastructure do wonders for the output per working hour. Jumping from medieval to state-of-the-art production methods often boosts labor productivity by factors in the double-digits. Corporate profits will increase correspondingly.

34. **The investment rationale of participating in these economic revolutions is irresistible.** By the end of the decade, China’s GDP will be just as large as that of the US or the euro area, but per capita incomes will still be just a quarter as high. Go east, young man, go east!

35. I also think that the **currencies of the key emerging economies will tend to appreciate.** One reason is the slow growth or the decline in unit labor costs mentioned above, the other is the financial solidity that is reflected in current account surpluses and high savings rates. Central banks will try to prevent a strengthening of their currencies by intervening in FX markets and by cutting interest rates, but longer term, market forces cannot be resisted.

36. In terms of asset allocation this means that **fixed income securities issued by borrowers from emerging economies will do rather well. They are a neglected asset class.**

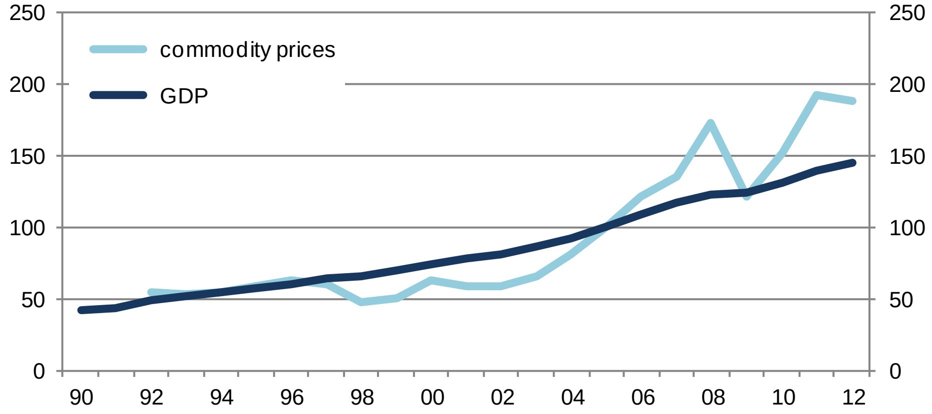
further investment ideas

37. Let’s begin a concluding tour d’horizon by looking at commodity markets. Given that global real GDP growth will probably remain in the order of 4 per cent on a purchasing power basis, **demand for raw materials and energy will expand by somewhere in the range of 2 and 3 per cent annually – as the commodity and energy intensity of production keeps declining**. But in absolute terms, we are still talking about robust growth rates. The graph shows that commodity prices increase broadly in line with nominal global GDP. In recent years they have been rising quite a bit faster and may therefore be on the high side.

38. **Commodity markets are famous for their booms and busts.** While prices may be solidly supported long term, they often form bubbles which will always burst at some point. The process is called mean reversion. When prices fall, they usually fall a lot, below trend. Some commodities such as iron ore, steel, nickel, zinc, lead and aluminum are trading between 35 and 70 per cent below their 2008 highs, others such as copper and gold have not corrected much.

commodity prices and global GDP*)

2005=100



*) indexes; nominal GDP in US dollars, on a PPP basis; commodities also in US dollars; 2012: estimates
source: IMF

39. Almost all commodities had rebounded briskly in recent months, mostly because **they were regarded as hedges against a euro break-up.** Since this is not so likely any longer, the near-term outlook is negative. This includes oil, coal and gas. I do not expect the lower turning point to occur any time soon. The world economy is still relatively weak. Note that the share prices of commodity producers are even more volatile than commodity prices - which suggests to short the former in a weak market.

40. Another idea is to **focus on stocks of firms that pay generous and steady dividends**. There are many whose current yield is much higher than that of government bonds. They are thus a plausible alternative for investors who need a strong cash flow. Sectors which come to mind are food, oil, chemicals, utilities and re-insurance. As mentioned earlier, there are also plenty of low-risk corporate bonds with attractive income streams.

41. **How can investors participate in the secular shift of the world economy toward emerging and developing economies?** Many are scared of the unfamiliar environment, the lack of transparency and a host of risks they are not even aware of – lots of unknown unknowns. One **cushion against these risks comes in the form of high risk premia**, the differences between equity earnings yields and "riskless" long-term yields of bonds which are denominated in the same currency. In mature OECD stock markets, these premia are on average in the order of 3 to 5 percentage points, but in an opaque market such as Russia they can be more than 15 points. Market participants think that **Russia is risky but cheap.**

42. An alternative approach is to i**nvest in Western companies which are strong in exports to and/or production in emerging economies.** The assumption is that these firms are aware of the risks in foreign places and know how to hedge themselves. German engineering and automotive multinationals come to mind, defense companies, all firms with popular global brands (food, luxury goods, consumer electronics, consumer software and so on), or successful providers of roads, airports, seaports or telecom equipment in wild and far-away places. In general, these firms are not particularly cheap – because hedging against massive risks has its price – but they are mostly growing fast and the well-established among them pay attractive dividends.

43. **One other stable trend that investors can hook onto is energy consumption**. While global real GDP can be expected to expand by something like 3 ½ per cent across business cycles, the consumption of energy will rise by less, somewhere between 1 ½ to 2 per cent annually. While this means that energy efficiency keeps improving, in volume terms the output and the consumption of energy keeps rising regardless. As the table shows, there are no signs yet that the production of oil, gas or coal has begun to shrink. No peak oil in sight! Energy stocks are not precisely sexy but they are usually financially solid and pay generous and steady dividends more often than not.

global production of oil, natural gas and coal

	oil	natural gas1)	coal1)	world GDP2)
		average annual change (%)		
1971-1981	1.6	3.1	NA	4.0
1981-1991	0.8	3.2	1.8	3.3
1991-2001	1.3	2.1	1.1	3.2
2001-2011	1.0	2.8	4.9	3.8

1) tonnes of oil equivalent; 2) constant prices, PPP-weighted
Sources: BP - Statistical Review of World Energy 2012, IMF; own calculations

44. **The steady increase of the world’s output of hydrocarbons means that rising emissions of greenhouse gases is de facto preprogrammed.** The quality of the air therefore continues to deteriorate and the globe heats up, contrary to the declarations of politicians, and no matter how fast alternative “clean” energy sources are developed. China is burning ever rising quantities of coal, while the US is discovering that it possesses huge reserves of shale gas and oil. Conventional energy could be more abundant than had been assumed until quite recently. As relative prices of conventional energy fall, there is the temptation to go slow on conservation. In other words, the world will get dirtier and warmer for some time to come.

45. The environment deteriorates in other ways as well: as household incomes grow – which they do as long as present GDP trends persist – land usage, water consumption or the demand for timber increase proportionally, and sometimes by more than that. All this puts severe strains on the environment. **Since a healthy and pleasant environment becomes something desirable once the basic needs for food, shelter and so on are satisfied, the demand for “green” products and services may rise quite strongly.** In this respect they are like luxury goods which only come on the radar screens of consumers when incomes are high. This is what we observe in the rich countries of Western Europe, and in Germany in particular. In other words, cleantech firms have the potential to rival IT companies in terms of long-term growth potential and are thus attractive for investors (I confess a home bias here).