



Wermuth's Investment Outlook

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1. **It is too early to call an end to the 30-year bond market rally in the US, Japan and the non-periphery countries in Europe. Growth is too weak in these countries for inflation to re-accelerate.**

Equities remain the better bet, mostly because of relatively high dividend yields and sound underlying financials, but they are not really cheap and can be hit anytime by disappointing GDP numbers.

Emerging market stocks have been neglected this year: valuations are reasonable, and catching up with the rich countries remains a convincing investment rationale.

Commodities are still expensive and will stay on the gentle downward trend due to sub-par global economic growth.

As to foreign exchange, currencies are driven by central bank aims and actions: yen and sterling will now stabilise, the euro is less risky than media headlines suggest, while the dollar flood prevents a lasting appreciation of that currency.

2. **Stock markets in safe haven countries** such as the US, Japan, the UK, Sweden, Denmark and Switzerland are doing very well this year; indices have either broken previous records or are close to it, with Japan the notable exception. Yet there is no sense of exuberance. As to the **euro area**, investors are cautiously optimistic so far, not only about Germany and France, but also about Ireland, Portugal, Greece and Spain, periphery countries where labor markets have been severely hit by the effects of fiscal austerity; only the Italian stock market is down this year, in response to the inconclusive outcome of recent national elections.

reasons for stock market strength

3. In the rich countries as a group, **stock prices and economic performance are disconnected**. Real GDP is expected to increase by a meager 1.0% y/y this year, after expanding at sub-standard rates of 1.4 and 1.2% in 2011 and 2012. This does not bode well for profits and profit expectations, the main determinants of stock prices in the medium term.
4. Obvious **reasons for the strength of stock markets** are extremely loose monetary policies - with short-term interest rates close to zero -, dividend yields which are high relative to government bond yields, and a feeling that risks are not larger than usual: the euro crisis seems to be on the mend following agreements to establish a banking union, China has recovered smartly from its brief spell of slow growth, and a war in the Near East appears, perhaps prematurely, to be less likely. It helps that commodity prices are falling, including the gold price, and that central banks will keep their foot on the accelerator.

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5. While OECD economies are characterized by very slow growth, high unemployment and low rates of capacity utilization, the **world economy as a whole is moving ahead, at a modest yet robust pace**. Emerging markets which account for 85% of the world's population and about half of its GDP are expanding, as a group, by more than 5% this year (using actual exchange rates). The probability of a significant deceleration of global growth is therefore small.
6. In other words, **European and American companies** that are facing stagnating demand at home have plenty of business opportunities in the vibrant emerging world outside. Increasingly, and including small and medium-sized firms, the world is becoming their "home market" - domestic demand trends are getting less important. This is especially true for countries such as Switzerland, Holland or Sweden, but also for Germany and even the US (think Silicon Valley or the oil majors).
7. Another reason for the surprising strength of the main OECD stock markets is the fact that **firms are also mostly cash rich** – they spend less on capital than in comparable post-recession years of the past. Sales expectations, which dominate investment decisions, are still rather subdued.

firms hold back on capital spending

8. Consumers are hesitant to part with their money because **real median incomes are stagnating or falling, and jobs are hard to come by**. International trade – which has been expanding almost two times faster than global real GDP for several decades - is increasingly exposing workers' wages to competition from laborers in emerging economies. This puts downward pressure on wages. Companies' labor costs are thus well under control, while the cost of capital has never been so low.
9. Wages in both rich and emerging economies are rising only slowly for another reason: routine work in particular is under attack from robots and internet systems. **To some extent, rich countries are presently faced with technological unemployment**. As in previous industrial revolutions, accelerating productivity growth will boost overall incomes, but initially the income distribution becomes more uneven – only those who have the right skills can demand higher wages, the others lose their jobs. There are more losers than winners. This is bad news for household demand in developed economies. The question is how long it will take until the new technology creates so many innovative products that even the less-skilled have a chance to find a job.
10. With the exception of Germany, labor force participation rates are falling in OECD countries, another reason why **households are not the drivers of final demand any more**, at least for the moment. For firms, it may be cheap to borrow money, and their profits may be high, but as long as consumer sentiment and sales expectations are subdued they have no strong incentive to create new jobs. They rather use their free cash flow to buy back equities and raise dividends. Shareholders are understandably happy.

tight fiscal policies everywhere

11. **Fiscal restraint is another factor that holds back final demand in the OECD countries**. Even though sluggish economic growth causes output gaps to widen further this year,

governments are determined to reduce their budget deficits, ie act pro-cyclically. Growth policies would be the right medicine in the present situation, but apart from the fact that no one really knows what growth policies would look like, politicians' overriding concern is to avoid becoming another Greece – or Cyprus! For governments the ultimate nightmare is to get cut off from capital markets and to have to bow to the diktats of foreign creditors. This would in effect force them to give up fiscal autonomy. It seems that once gross government debt has reached something like 100 per cent of GDP, there is no alternative to deficit reduction, especially for countries whose net foreign assets are negative. Fighting unemployment and social unrest moves to the number two spot on the list of priorities.

12. **Because of its net creditor status vis-à-vis the rest of the world, Japan has not been troubled by its huge public sector debt:** over the course of several decades the country has accumulated massive foreign reserves, the legacy of persistent current account surpluses. JPMorgan estimates that general government net borrowing will be 11.5 per cent of GDP in 2013, after 10.6 per cent last year. Gross government debt will exceed 250 per cent of GDP by the end of this year. In spite of these awesome numbers, the yield of the 10-year government bond is just 0.59%!
13. While Japan pursues slightly expansionary fiscal policies, the **US administration continues to tighten its belt.** Since the Bush tax cuts are now permanent, the only way to reduce budget deficits is sharp cuts in public services and investments which is the opposite of what America needs. But Mr. Obama has no political leverage at this point to boost revenues.
14. As a result, **real US government spending will decline further 2013, perhaps by another 1½ per cent in 2013,** as in 2012. According to the recent winter forecast of the European Commission, the overall deficit is likely to decline from 8.5 to 6.6 per cent of GDP whereas the debt-to-GDP ratio goes up 3½ percentage points to 111 per cent. Since the US continues to run balance on current account deficits, it remains dependent on capital imports which in turn requires sound budget policies. A yield of 1.90% on 10-year Treasuries – zero per cent in real terms - is a sign that investors are not worried much about America's ability to serve its debt.
15. As it looks, **pro-cyclical fiscal policies do not cause much damage** because the real estate sector is reviving, the deleveraging of household mortgage debt is approaching its end, and business sentiment and employment have been quite strong recently. Most banks are in rude health again.

... including the euro area

16. **Fiscal policies in the euro area are also restrictive.** Real government spending will decline by about one half per cent between 2012 and 2013. The EU Commission forecasts that the aggregated deficit of the 17 member states will fall from 3.5 per cent to 2.8 per cent of GDP this year. As a whole, the currency union is about to meet the Maastricht deficit criterion! This is mostly because a few countries are running very small deficits: Germany 0.2, Finland 1.5 and Italy 2.1 (!) per cent of their respective GDPs. Others are still struggling: especially Ireland (7.3), Spain (6.7), Portugal (4.9) and France (3.7).
17. In a well-functioning currency union, **Germany, Finland and Italy** would be spending more freely or cut taxes, and in this way boost demand and help to ease the pain of austerity policies in the rest of the region. In Germany in particular, politicians do not dare to suggest

such a strategy: they are afraid that the “sinners” would quickly abandon their reform efforts and just postpone the day of reckoning. The final bill to the taxpayer would inevitably go up. Moreover, the September national elections are approaching: **expansionary fiscal policies to the benefit of European partners are unlikely to be vote winners for Ms Merkel.** Her government is proud to be balancing its books this year, to have kept the economy growing and to have created lots of new jobs in a difficult international environment. Voters do not mind, or are not aware of, that fiscal policies are de facto restrictive and that Germany itself contributes to the euro crisis.

18. **Ambitious fiscal consolidation is increasingly straining the social fabric in Italy and Spain.** Because these countries are so big, draconian measures like they are proposed for Cyprus are inconceivable. Italy has only a caretaker government right now because Grillo and Berlusconi – both of whom rode on anti-euro election tickets - won so many votes recently; their parties do not want to enter a coalition government, or do not qualify. Unemployment is at 11.2%, while employment continues to fall and is 2½% below the peak of 2Q 2008.
19. **Following the collapse of its oversized real estate sector, Spain’s labor market is in even worse shape than Italy’s:** the unemployment rate is a staggering 26.1% and employment is down 15% from its 2007 high. Every second young person is without a job. At the same time, the government has committed itself to reduce the state’s budget deficit from 10.3% of GDP last year to 6.7% this year. This comes close to a suicide attempt. Incidentally, until 2007, Spain was the model student of the currency union – with government debt just 36.2% of GDP.
20. **In both Italy and Spain real GDP will fall again this year.** The EU Commission predicts declines of 1 to 1½%. This is a plausible prediction. It is less clear how the situation can be improved. The recovery is supposed to be well established by the 2014. Faster growth in the rest of the euro area (2.0% y/y) and the world economy in general (3.1% y/y) is one supporting factor, another may be the simple fact that all recessions end at some point, typically when production has fallen so much that it is less than demand. Easy money also helps. An early recovery still looks a lot like wishful thinking.

inflation is not an issue any longer

21. In any case, slow growth and widening output gaps mean that the **outlook for inflation remains very favorable.** Consumer price inflation in the OECD area will average about 1½ per cent in 2013, with both the euro area and the US at 1.8% y/y, and Japan at 0.2%. Even lower rates can be expected in 2014. Inflation has ceased to be an issue that worries people.
22. **The ECB, the Fed, the Bank of Japan and the Bank of England can thus afford to keep policy rates near zero and provide banks with all the liquidity they ask for.** There are no indications that the reins will be tightened any time soon. Since fiscal policies are so restrictive (except in Japan) a powerful counterweight is needed to stabilize and hopefully stimulate demand and production. In Europe and Japan, all the money printing has yet to stimulate economic activity. In the US, however, long-term interest rates, pulled down by ultra-low money market rates, have begun to spark a recovery of housing, autos and other durable goods. Ben Bernanke of the Fed continues to argue that the benefits of low rates and QE3 money printing (\$85bn a month) outweigh the costs.

23. **The question is whether new credit bubbles are developing.** Loans are abundant in the safe haven countries of the OECD. Investors are once again in search of yields and are buying riskier securities. There is a boom in junk bonds and, of course, in equities. Leveraged buy-out managers can find debt at attractive terms these days and are awakening from hibernation. The strength of stock markets is at least partially driven by easy money. Even so, it is still early days and in no way is the situation comparable to the heady days of 2007. A warning: one defining feature of bubbles is that they are rarely recognized as such in real time.

why the US is doing better than the euro area

24. It is **puzzling that the US economy responds much more positively to expansionary monetary policies than the euro area.** Real GDP growth in the first half of 2013 is running at an annualized rate of about 2 per cent, compared to virtual stagnation of output in the 17-country currency union.
25. I guess that the forced nationalizations, debt reductions and re-capitalizations of major American banks, followed by privatizations, have done the trick. **A powerful Treasury and centralized resolution authorities for banks and insurance companies were able to act quickly** and without financial constraints when the crisis hit, whereas the Europeans had no equally effective policy tools.
26. Judging by price-to-book ratios, the **euro area is still full of zombie banks** which do not dare to lend. Just a few numbers: Commerzbank trades at a ratio of 0.32, Intesa at 0.39, Unicredit at 0.33, Cr dit Agricole at 0.43, Soci t  G n rale at 0.47. Even Deutsche Bank, at 0.55, is hardly a rock solid institution any more in the eyes of market participants. Among the large US banks, Bank of America is the weakest, at 0.63. JPMorgan has a p/b ratio of 0.96, Citi of 0.77 and Goldman Sachs of 1.03. These are not stellar valuations but they are still quite a bit better than those of their euro area peers.
27. **The looming insolvency of Cypriot banks and the Cypriot government** will focus the minds of euro area finance ministers. The likelihood of establishing a bank resolution authority, following the decision about a central bank supervisory authority associated with the ECB, has increased considerably. It is now obvious that the currency union does not have a future without a fully-functioning banking union. Monetary policies can only be effective with full financial integration. The fragmentation of the euro area money and capital markets that has intensified over the course of the financial crisis has to end. It will end because it must – the cost of letting the euro area break up is simply too high.

euro banking union well on its way

28. **Here is what EU lawmakers and national governments have provisionally decided this week.** The quote is from Bloomberg: "... the ECB will directly oversee around 150 banks, accounting for more than 80 per cent of the euro area banking system in terms of assets, according to the central bank's own estimates. The ECB will directly oversee at least the top three ... banks of every participating nation unless "justified by particular circumstances". Establishing the single supervisor is a condition for allowing direct bank aid from the euro area's firewall. Finance ministers have pledged to agree on guidelines for such aid by mid-year."

29. This is actually a big step forward. While it is conceivable that Cyprus may yet be allowed to fail, the safety net for euro area banks and governments is quickly getting stronger. The combination of financial assistance for troubled institutions, where the strong help the weak, and conditionality is the guiding principle in building an integrated financial market and making the euro a fully-fledged reserve currency. **The risks associated with euro assets are smaller than currently perceived by market participants. To buy the euro on weakness, ie right now, looks like a sound strategy to me.**
30. It would be a great relief if the euro risk simply faded away in coming months as panicked policy makers cannot but build a resilient banking and transfer union. From a fundamental perspective, **key components for an economic recovery are actually in place:** easy monetary conditions, a weak exchange rate, a fairly high rate of growth of global GDP and the need to modernize the capital stock after several years of subdued capital spending. In aggregate, there is also no need for a further tightening of fiscal policies.
31. **The big unknown is the European consumer:** according to the EU Commission, real per capita compensation will rise by just 0.2 per cent, after declines in the previous two years. With unemployment at almost 12 per cent and rising, one wonders how consumer sentiment could improve. In the US, where real compensation is actually expected to decline this year, and where the so-called underemployment rate is still 14.3 per cent, consumers have actually begun to spend quite briskly again (in real terms +1.8% y/y in 2013, says the EU). They will, as so often in the past, just reduce their saving rate, from 8.3 per cent in 2012 to perhaps 7.7 per cent this year. In the euro area, the present saving rate of no less than 13.3 per cent suggests that consumers have the same option.
32. A lack of money is not the issue, it is just a lack of confidence. **Creating a resilient institutional framework for the euro could be the trigger that finally releases household demand.** Private consumption has been depressed for no less than five years: in 2013 it will still be about 2 per cent lower than in 2008 - and that is in real terms! In the ten "normal" years before the financial crisis, trend growth had been 1¾ per cent annually.
33. **In other words, the potential for a vigorous economic expansion in the euro area is there. If the political process toward a more integrated euro area does indeed gain momentum and becomes irreversible, even in the eyes of skeptical market participants, I would expect a big boost to economic growth, stock prices and the euro exchange rate. Yield spreads between euro area government bonds would decline a lot. For the world economy as a whole, a key risk would have been removed, leading to lower risk premia and an acceleration of growth, including somewhat higher inflation expectations.**

commodity prices and exchange rates

34. **Commodity prices would also gain from such a development. But their general trend will remain downward sloping,** for two main reasons: prices are still very high, and supply has expanded in response to those high prices. Take **Brent oil:** a barrel costs \$109 today which is lower than the peak reached in 2008 (\$145), but far above the price of ten years ago (\$27). Falling gas prices and competition from shale oil will push down prices. **Iron ore** costs \$498 a ton, 73 per cent less than at its peak in 2007, yet 80 per cent more than in March 2003. Large new mines will become operative shortly which has pushed futures prices down steeply. Or **aluminum:** presently 42 per cent less in November 2008 but still 40 per cent

above March 2003. And so on. There are no genuine supply constraints. Keep in mind that marginal costs are very low once new production facilities have been installed.

35. **The gold price?** Refinancing rates near zero mean that it is not expensive to hold gold. But they cannot get much lower. So this effect does not have an impact on its price any longer. Gold as a hedge against the demise of paper money, the euro in particular? Unlikely in my mind, as European politicians seem to get their act together and are about to create a solid institutional framework that will secure the survival of the young currency. A hedge against rising inflation? For now, inflation rates in the OECD area are trending down toward 1½ percent in the rich countries, and toward 4½ per cent in emerging economies – for the latter, this is what they would regard as price stability, given medium-term growth rates of real GDP and labor productivity of well above 5 per cent. A quick acceleration of global inflation is unlikely because output gaps will not be closed for at least a decade, judging by the Japanese post-bubble experience. In other words, no one should speculate that the gold price will rise anytime soon.
36. **Exchange rates have settled down after the large depreciations of the yen and pound sterling.** If the new boss of the Bank of Japan is really determined to achieve a 2 per cent consumer price inflation rate, the easiest solution would be to keep aggressively selling yen against dollar and euro – this leads to a depreciation of the yen, thus to higher import and export prices, a large expansion of central bank money (via foreign currency reserves) and a rising domestic price level. But there are obvious limits to that strategy: retaliations such as a capital controls and trade restrictions. I would conclude that the yen will depreciate somewhat more but that most of the depreciation has occurred already. The current account, the key long-term determinant of the exchange rate, is still in surplus and would start to get larger in response to a weaker yen.
37. **Sterling has more downward potential**, especially if the euro bottoms out sometime soon: the government budget deficit will be almost 8 per cent of GDP, the current account deficit about 2½ per cent of GDP in 2013, GDP growth is just 1 per cent, and monetary policies are very expansionary.
38. Among emerging market exchange rates, the **renminbi is well supported** by robust economic growth in China, causing a strong demand for Chinese assets, a large current account surplus and a small government budget deficit (2% of GDP). The currency has been more or less unchanged for almost five months against the dollar. A resumption of its gradual appreciation is therefore likely.
39. **The rouble** fluctuates within a rather narrow band against its dollar/euro basket, in spite of an inflation rate of more than 6 per cent and disappointing economic growth. The support comes from high commodity prices and a current account surplus of about 2½ per cent of GDP. If I am right about a gradual fall of commodity prices that support will become less powerful and push the rouble down somewhat over the next year.

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