WEBLOG


# Wermuth's

# Investment Outlook

## September 2013

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# Wermuth's Investment Outlook

## by Dieter Wermuth*

**September 5, 2013**

1. Near term, financial investors are concerned about **three main risks:**

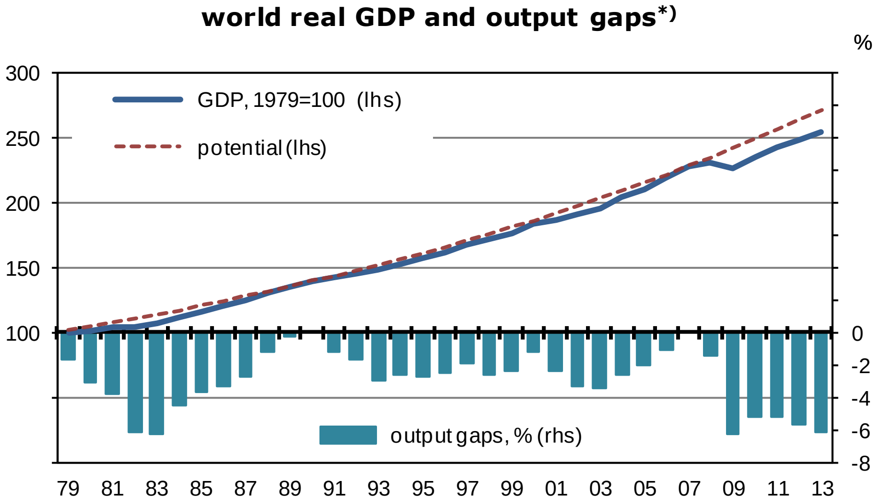
   - Will the conflicts in the Near East escalate further and spread to other countries in the region, causing another global oil crisis?
   - Will long-term interest rates in the rich countries continue to rise and become a break on global growth?
   - Will there be a new crisis in emerging economies?

2. **The world economy has been on the mend recently**: China will not fall from a cliff and drag the rest of the world into recession; the US economy may by now be on track to a self-sustaining expansion, in spite of tight fiscal policies and the deleveraging strategies of households and banks; and the threat of a euro area break-up has receded as it becomes clear that Greece and the other weak countries will in one way or other be supported by the rest, as well as by the ECB. Inflation is below target in the euro area and the US, but deflation is not an imminent threat.

3. **These positive developments could end if the risks listed in the first paragraph do indeed materialize.** The world economy is not yet in a robust state of health and thus ill-prepared to withstand shocks. In particular, unemployment in some large OECD countries such as the US, Britain, France, Italy and Spain is still very high - GDP growth is too slow to generate enough new jobs. Output gaps are wider than anyone can remember. The income distribution, meanwhile, has become dangerously uneven under the impact of globalization and firms' emphasis on maximization of shareholder value and a winner-take-all mentality, especially in the rich English-speaking countries, but also in most emerging economies.

4. **In 2013, the world's real GDP will probably exceed last year's level by 2.2 per cent,** after expanding by 2.6 per cent in 2012. This is on the basis of actual exchange rates, not purchasing power parities. In the ten years before the outbreak of the financial crisis in the OECD area, the average growth rate had been 3.1 per cent. No matter how one calculates, it is clear that **the world economy is operating far below trend and thus far below its potential.** There are no signs that the output gap is closing, especially not in the euro area whose recession is the main drag for the world economy. Almost nowhere is inflation a near-term concern.

* 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.

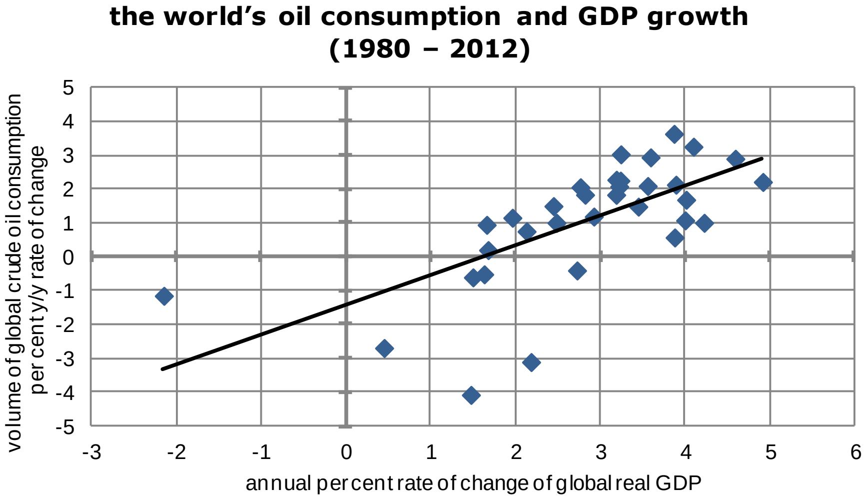



*) at market exchange rates; slope of trendline: 2.9% pa

sources: International Monetary Fund; own calculations

## a new global oil crisis would have deflationary effects

5. Given these poor fundamentals, the present **oil price of $115** per barrel is extremely high. To recall, in the 15 years to the middle of the last decade, it had fluctuated around $20. The high oil price has been one reason why the world economy has not been picking up speed. **Why is it so high?** The main explanation is the ongoing shift in the structure of demand: while oil consumption in OECD countries stagnates or falls, buoyant emerging economies more than compensate for this effect: car ownership, air transportation, air conditioning and the consumption of energy-intensive manufactured goods are all up sharply in that part of the world. Overall, oil demand is therefore still rising. The following non-scientific graph suggests that 1 per cent of global real GDP growth goes along with a 0.6 per cent increase in oil consumption, on average that is. Variations around the average are quite wide as one can see. Another tentative message of the graph: if the world economy expands by less than 1½ per cent, oil consumption is likely to shrink.



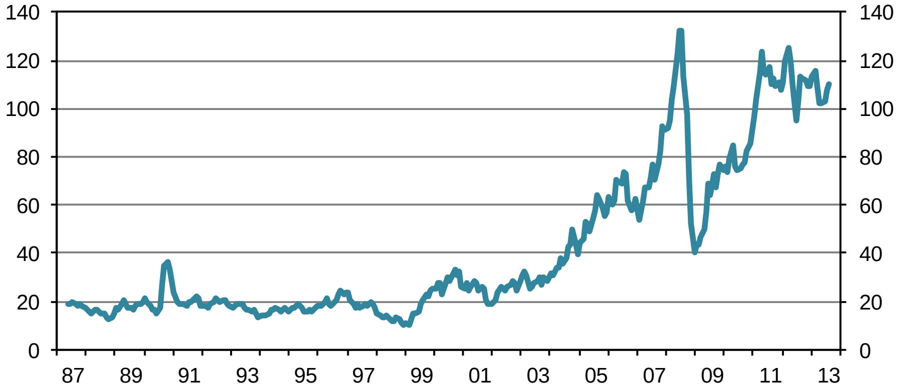

sources: IMF, BP Statistical Review of World Energy 2013

6. On the other hand, **historically high prices have stimulated oil production**. It now pays to exploit fields in the arctic, in deep water and in areas which were believed to be near exhaustion. Costly production from shale is up steeply. The US is therefore in the middle of an oil boom and on the road to self-sufficiency. Global oil production easily matches demand so far, meaning there are no bottlenecks on the output side of the equation.

7. This implies that today's oil price must be kept up by non-economic factors, most likely by fears that the Near East powder keg may soon blow up. There is civil war in Syria and Egypt, Iran continues to pose a threat to Israel and may provoke a military strike, and fundamental Islam may yet target the autocratic regimes of the Arabian heartland.

**the oil price**

– Brent, dollars per barrel, monthly averages –




source: Thomson Reuters

8. If the situation does indeed escalate, oil production would be severely hit. At the same time, everyone would try to increase their crude inventories. With production down and demand up, **earlier predictions of $200 a barrel would once again look realistic.** In such a case, the three main net oil importers, the US, the euro area and China - which because of their size also determine where the world economy is heading – would be pushed into recession or at least grow at a much lower rate than today.

9. While general inflation would rise near-term, the net effects of higher oil prices are deflationary. **Because so much more money must suddenly be paid for oil imports, less is left for other products and services.** This reduction of demand would widen output gaps, lead to an increase of unemployment and make it even more difficult for firms and workers to raise prices and wages.

10. It is clear that in such a scenario **stock markets in (net) oil importing countries would decline a lot**, perhaps even crash, **while high-quality bonds would gain.** Since late spring, bond prices in what used to be safe-haven markets have fallen to attractively low levels.

11. **Other winners would be energy stocks of net oil exporting countries** which are not affected by political unrest, such as Russia and Norway. Since they are mostly running current account surpluses their currencies would probably appreciate as well.

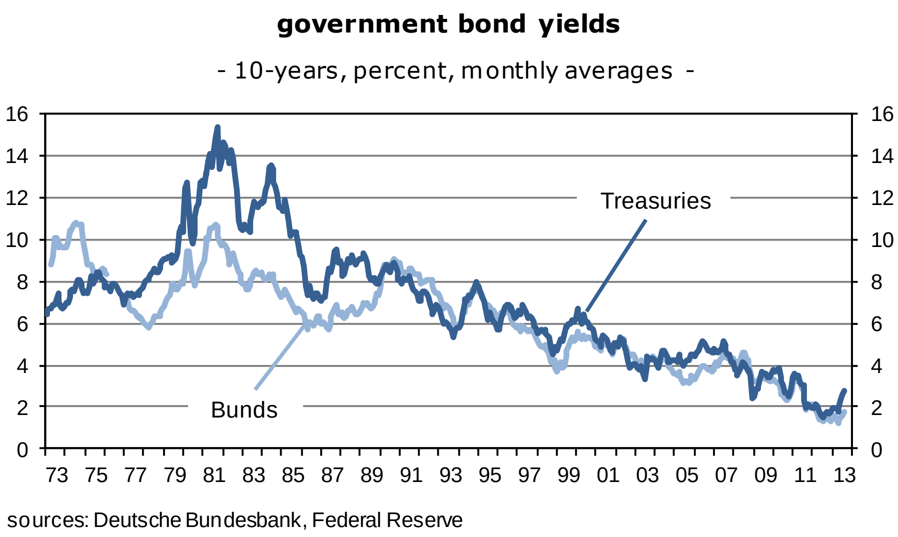
12. Incidentally, a much **higher oil price would do wonders for the environment** – as energy consumption falls. The business models of many alternative energy producers and resource

efficiency firms would become viable and attractive, not least because government subsidies would flow more freely again. Most of the leaders in resource efficiency and green technologies are in western Europe.

13. **To sum up, there is a non-negligible risk of a new oil price explosion**. On purely economic terms, the oil price is too high, though. It is mostly politics that prevents it from falling. Investors must keep a close eye on developments in the Near East.

## rising long-term dollar interest rates

14. The next risk that is keeping investors awake at night is the sudden increase in long-term yields of high-quality bonds. **At some point the 30-year bond market rally had to end.** In the fall of 1981, when it began, investors were able to buy 10-year Treasuries at a yield of 15.3 per cent, and Bunds at 10.7 per cent! These were the days!




15. **Could it be that the turning point had occurred in early May this year when 10-year Treasuries and Bunds were at 1.63 and 1.16 per cent?** (the post-war low of Treasury yields was actually 1.39, on 24 July 2012). Yields could obviously not fall much more even though the Swiss and Japanese have shown that they could, to well below 1 per cent. But why bet on this to happen? The US and German bond markets are not such safe havens as Switzerland, and the likelihood of a long-lasting Japanese-style deflation looks fairly remote. So it made sense for investors to lock in profits and finally sell some of the bonds which had earned them so much money.

16. In the meantime, 10-year Treasuries have gone up 128 basis points to 2.91 per cent, and "Bunds" 77 bp to 1.94. Monetary conditions have thus become tighter and could hit the housing market in particular. **The back-up in bond yields came despite efforts of the Fed and the ECB to reassure markets that for years to come policy rates would stay at their rock-bottom levels**. Ben Bernanke has said that rates would only be raised once US unemployment reaches 6½ per cent – at its last reading it was at 7.4 per cent. The last cyclical high was in October 2009, at 10.0 percent. Since a rate of 6½ might be reached rather quickly as the US economy picks up momentum, the Fed has indicated that the threshold might be

lowered to perhaps 6 per cent. Keeping policy rates near zero for a long time has top priority right now, so milestones may be moved if needed.

17. At the moment though, the **assumption of US policy makers is still that the reduction of the unemployment rate will take time**: they expect that the labor force participation rate – which remains depressed - will go up briskly as it becomes easier to find jobs. This effect reduces the pool of discouraged workers and means the available labor supply and the number of job seekers will go up, slowing the reduction of the unemployment rate.

18. Overall, there is still **a lot of slack in the US economy, so the inflation risk will remain small** for the foreseeable future. Core consumer price inflation is around 1 per cent year-on-year and thus far below the Fed's 2 per cent target.

19. **The ECB has not yet stated under which conditions policy rates might be raised.** The next step will actually not be an increase but another cut in the main refinancing rate later this year, from presently 0.5 to 0.25 per cent. With unemployment at a record 12.2 per cent, it is unlikely that President Mario Draghi will commit himself to a US-like target rate of 6½ per cent or so – it could easily take a decade to get there.

20. Alternatively, and far more realistically, he **may permit headline consumer price inflation to hit 2½ per cent before raising rates.** Here the problem is that a huge oil price increase in the wake of a hot war in the Near East might quickly push up inflation into this region. Tightening monetary policies in the face of a recessionary oil price shock is counterproductive. So far, the ECB, in the tradition of the Bundesbank, does not target core inflation (CPI ex food and energy), but sometime down the line it will have to. Exogenous shocks cannot be avoided and should not have an adverse impact on monetary policies. The last reading of euro area core inflation has been 1.1 per cent year-on-year.

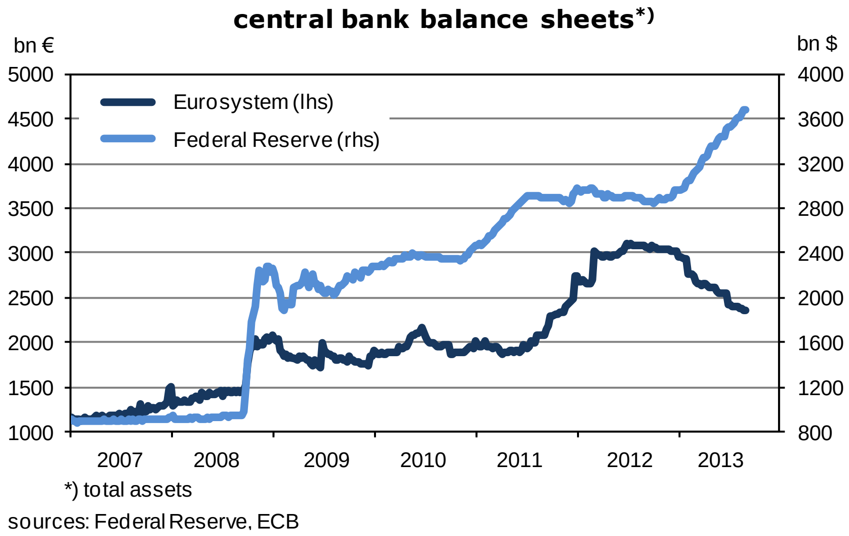
21. **Long-term interest rates can be interpreted as the product of expected money market rates.** If investors believed central banks' announcements about holding down policy rates for years they should not have been selling their bonds since last May. The Fed and the ECB are trying, but have not succeeded to control the entire yield curve by making those strong statements. There are either other factors than money market rates that drive long yields, or investors reckon that central banks will actually be unable to make good on their commitments. For now at least, they are obviously not afraid of deflation. Their bet is that stronger economies will lead to inflation pressures and thus higher bond yields. They are probably mistaken.

## the coming disappearance of the main buyer of Treasuries

22. The large increase in American and European long-term government bond yields since May 2 had at its origin the **Fed's announcement that its monthly $85bn net purchases of Treasuries and bonds of state-owned mortgage providers would soon be phased out**. $85bn per month is $1,020bn per year and equivalent to 6.4 per cent of GDP. This compares to a likely 2013 government budget deficit of 4.5 per cent of US GDP. The prospect that such an important buyer is about to withdraw from the market has shocked investors.

23. The Fed has flooded the banks with central bank money for more than one year now. In the meantime, there are signs that the US economy is expanding in a self-sustaining fashion. Real

GDP seems to have increased at an average annualized rate of 2.5 per cent in the present and previous quarters – which is close to the growth rate of potential GDP -, and employment has been rising at an annualized rate of 1.7 per cent over the first seven months of 2013, faster than the "natural" rate of growth of the labor force. **The Fed felt it was time to take away the punch bowl, to stop excessive money printing, to normalize policies.**




24. **Inflation expectations, an important driver of bond yields, have hardly moved in the US.** According to 5-year inflation-linked government bonds, they are still averaging a modest 1.72 per cent over the next five years. The rate is 2.12 for ten years. As it is, on a net basis the only buyer of long-duration US government paper has been the Fed for quite a while now. Other buyers of American bonds must soon fill the gap: by definition, this must be foreigners and the US private sector. They are demanding higher yields than the Fed.

25. **The question is how far long-term interest rates may rise, if at all.** I think it is a safe bet that US money market (LIBOR) rates will remain in today's range between 0.18 (1 month) and 0.67 (12 months) per cent for at least two years. The cost of carrying bond portfolios (10-year Treasuries yield 2.9 per cent, corporate bonds quite a lot more) is thus very low. This will prevent a genuine bond market rout. By now, fixed-income securities have become attractive, especially in case another oil price explosion unleashes deflationary forces.

26. I think we have arrived at a point where some rotation out of developed market equities makes sense, if only to lock in previous gains – and to hedge against the risks of an oil shock and, in its wake, a global recession.

27. Another question is: **why has the market for German Bunds followed so closely the market for Treasuries since last May?** As mentioned, the yield increase has been 77 basis points which is not qualitatively different from the 128 basis point increase of Treasury notes. One factor that has been negative for the Treasury market did not play a role: something like the coming end of QE3. The ECB has not been in the market to buy euro area government bonds and could thus not stop buying them! This cannot be an explanation for the decline of German bond prices. Under the OMT program, announced last September, the European Central Bank can buy bonds, but only of countries that have applied for EU funds and participate in restructuring programs. The facility has not yet been activated to date.

28. In other words, **the weakness of euro area bond markets is not homemade**. There has been some improvement of the economic situation, but nothing that would suggest an imminent pick-up of inflation. In July, core inflation was only 1.1 per cent y/y, headline inflation 1.6 per cent. The long recession has perhaps ended in Q2 when the currency union's GDP expanded by 0.3 per cent quarter-over-quarter; purchasing managers' indices are in positive territory and keep rising. I expect that quarterly growth rates will be in the order of - a less-than-breathtaking - 0.3 to 0.4 per cent from now on. For 2013 as a whole, real GDP will still be down 0.5 per cent from 2012. There are no signs yet that 12.2 per cent marks the turning point in the trend of the unemployment rate.

29. **I guess a simple arbitrage process has been responsible for the weakness of euro area bonds**: as the value of US debt in internationally diversified portfolios came down its share dropped below the benchmark. Treasuries and Bunds are close substitutes which means that in order to reestablish the old – or targeted - portfolio weights, Bunds had to be sold – which in turn caused their weakness.

## the euro seems to make it

30. **The euro area is not news any longer**. In creditor countries such as Germany, Austria, the Netherlands and Finland the public has more or less accepted that further financial transfers and debt guarantees for peripheral countries will be needed while these have accepted that they need to restructure their economies as demanded by the lenders; this is painful but also to their benefit in the longer term, and necessary for the long-term cohesion of the currency union.

31. **Moody's, the rating agency, has just published a surprisingly positive report** on the progress made on this front. To quote from its Summary, "The countries in the euro area periphery ... have made significant progress towards addressing internal and external imbalances and the associated losses in competitiveness that were among the drivers of the unsustainably high public debt burdens. If continued, the improvements ... will be an important influence on future sovereign credit quality ..." (Moody's Investor Services: "Update on Structural Reforms in the Euro Area Periphery", New York, August 2013). The agency hedges its bet by pointing out that not all is well: there remain considerable further adjustment needs, the institutional developments at the euro area level must continue, and growth is much too sluggish. Ratings will thus not be raised in the near term.

32. Hearing this not from the ECB or from some interested European politician but from a neutral observer based in New York is quite reassuring. **Spain and Italy, the largest crisis countries, have begun to run current surpluses.** It means they have become net capital exporters and are repaying their foreign debt, if only just a little so far. Market participants have begun to take note. The increase in Italian and Spanish 10-year government bond yields since early May has been just 66 and 47 basis points, less than "safe" Germany's 77. **Yields are around 4½ per cent which makes these bonds attractive for investors who believe in the future of the euro and look for some diversification of risk**.

33. **The weak spot in the euro area normalization process is France**. Some observers fear that the country is on the way to joining the periphery. Real GDP is still lower than before the crisis: since the country's population has increased by 2½ per cent during those years, per

capita GDP is down quite a bit, and so is the standard of living. Unemployment is up by no less than 300,000 over the past year which has driven the unemployment rate to 10.9 per cent (Germany 5.3, both rates according to the definition of the International Labor Office ILO). The balance on current account remains in deficit (2 per cent of GDP) while the government budget deficit is stuck at 4.3 per cent of GDP this year.

34. **The extremely high share of public sector spending in GDP makes it very hard to stimulate the economy via fiscal policies.** Just the opposite, taxes and social security contributions are raised in order to bring down the budget deficit to 3 per cent, as required by the Maastricht Treaty. France will grow by perhaps 0.2 per cent this year. There are no significant structural reforms on the way that might boost employment and productivity.

35. With pro-cyclical fiscal policies the order of the day, it is hard to see how a self-sustaining recovery may come about in France. The best hope is that the other economies of the euro area generate so much momentum that they will drag the country along. **Financial investors are skeptical**: French 10-year government bond yields have increased by 87 basis points since early May, to 2.53 per cent, more than those of the other large euro area bond markets.

36. **The likelihood that average euro yields will rise significantly from here is small, mostly because the ECB will continue to anchor short-term rates near zero**. There is also a lack of signs that inflation expectations are on the rise. On balance, monetary conditions have tightened as real longer term yields have moved from negative to positive. The appreciation of the trade-weighted inflation-adjusted euro – its real exchange rate – over the past year works in the same direction.

## monetary policies have lost their punch

37. The above analysis suggests that the ECB is running out of ammunition, just as the Fed, the Bank of Japan and the Bank of England. Monetary policies in rich countries have been losing their punch as policy rates are about as low as they can get. **Flooding the markets with central bank money and promising to keep rates near zero for a long time are untried instruments with limited positive effects in the short run, and uncertain effects in the long run.** Are they creating new asset price bubbles, just as after the 2000/2001 recession?

38. In general, the aim of monetary policies is to induce households and enterprises to borrow more money again and generate additional demand for goods and services, and create higher inflation along the way. In the euro area in particular, debt reduction is still a priority, though, not least for governments, so **to convince economic agents to increase their debt again is quite futile. A so-called balance sheet recession will not end because of easy money.**
39. **One should not expect too much from monetary recipes any longer. The influence of central banks on growth and employment is clearly overrated.** What is needed are policies that boost the growth rate of the capital stock and potential GDP. This calls for rising government spending on investment and education and going slow on the reduction of deficits. It does not make sense trying to get back to the situation before the financial crisis – those policies have got us into the present mess.

40. In the euro area, partial debt forgiveness, pushing ahead with the banking union and further steps towards issuing euro bonds backed by the member states are other important measures going forward. **On an aggregate level, the euro area is fundamentally surprisingly**

**sound:** government budget deficits will be less than 3 per cent of GDP this year, and the balance on current account will be in surplus – it could well turn out to be the world's largest. Provided sufficient solidarity among the member states, policy makers in the currency union have clearly some room for manoeuver. Much faster inflation-free growth is a genuine possibility if they can agree on coordinated forward-looking strategies. I have to admit: this is wishful thinking. Perhaps another life-threatening crisis is needed to overcome their complacency and their tendency to muddle-through rather than look for comprehensive solutions.

## crisis of emerging markets will not seriously derail world economy

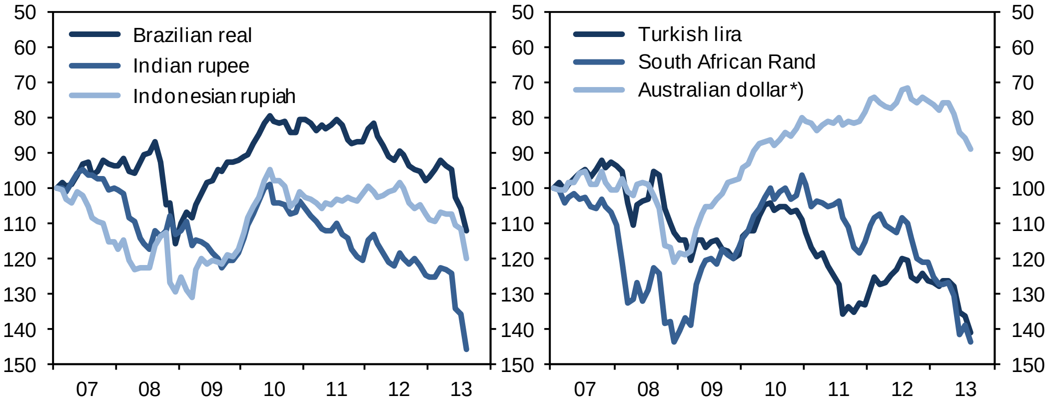
41. For investors, **emerging market (EM) equities have been disappointing this year**. All big stock markets have declined by between 5 and 10 per cent, from Brazil, South Africa, Russia, Turkey to China, India, Indonesia and Thailand, while OECD markets are well ahead: Japan (35%), US (Nasdaq 20%, S&P 500 15%), Milan and Madrid both almost 3%, Frankfurt 7%, Paris 8½%. Corporate earnings in the rich countries are surprising on the upside, in spite of sluggish economic growth and, in the euro area, a recession. Investors are not so upbeat about the earnings outlook of EM companies. The love story with them has ended. It will surely be revitalized, but probably not in the near-term.

42. **There is also capital flight from those EM countries which are running deficits in their balances on current account.** Countries which have not relied on capital imports such as China or Russia – they are net capital exporters - continue to have stable, if not appreciating exchange rates. Note that current account deficits are invariably accompanied by sizeable government budget deficits, something that is less than reassuring for risk-averse investors.

43. The following graphs show the sudden depreciation since last spring of some of the currencies that used to be boosted by substantial net capital imports but are now in the firing line of portfolio investors and speculators.

**emerging market exchange rates against the euro**

Jan. 2007=100




*) OECD country Australia has been included because of its dependence on commodity prices and its large current account deficit

source: ECB; own calculations

44. **What has happened, will this continue, and what are the likely effects on the rest of the world?** The trigger, as in the case of OECD bond markets, has been the prospect that the Fed will soon start to eliminate itself as the main buyer of longer-term US government debt. Financial investors accept the Fed's argument that the American economy is doing all-right, but the conclusion they draw is different from the one the Fed would like them to draw: that the end of easy money is near.

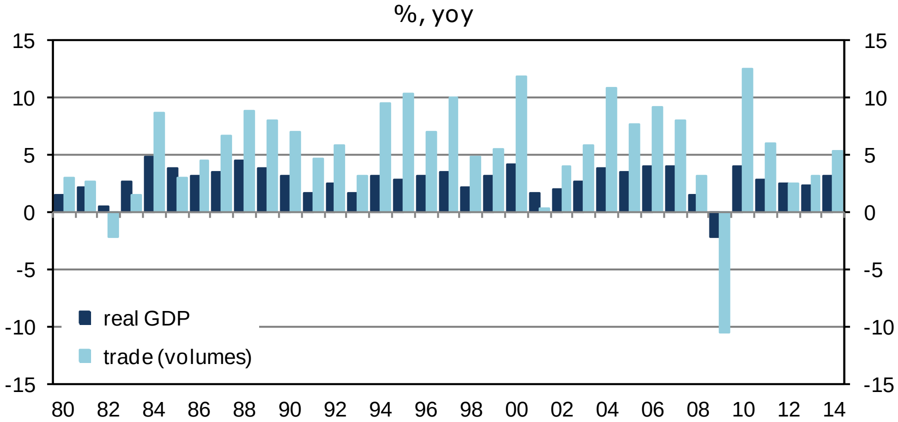
45. So-called **carry trades** where one borrows dollars at very low interest rates and invests them in higher-yielding EM assets are seen as increasingly risky and are therefore wound down – which hurts stock markets and exchange rates. Profit taking is something normal, but since the affected markets are relatively small and therefore not so liquid, stop-loss orders of foreign investors tend to have stronger self-fulfilling effects than they would have in more mature markets.

46. Politicians in emerging economies complain that they are at the mercy of the Fed's interest rate decisions, and that the Fed couldn't care less about the impact on the rest of the world. That's quite right, but it had been their own decision to prevent an appreciation of their currencies; they **preferred to buy dollars in FX markets in order to keep their currencies undervalued.** Their growth model consisted of promoting exports. The flip side was that these interventions created very easy monetary conditions.

47. As the next graph shows, world trade has been expanding much faster than the world's real GDP. Over the period 1990 to 2014 the volume of trade has on average expanded 2.2 times faster than global output: so it made sense to participate in the international division of labor (called globalisation) – but it brought with it, as we now see, financial instability and market volatility. If one looks at the long-term economic growth performance – which is much stronger than that of the rich countries – one must conclude that on balance their strategies have been quite successful.

**global GDP and world trade*)**

%, yoy




*) at market exchange rates; 2013, 2014 IMF projections

source: International Monetary Fund

48. **EM politicians could also have introduced capital controls** when carry trades began to create bubbles, ie, market disequilibria, but this ran, and still mostly runs, against the prevailing ideology. Moreover, because of their feel-good factors politicians like bubbles.

49. **The situation remains volatile**: the Fed not even begun to reduce the volume of monthly bond purchases, while the risk of a war in the Near East is very high. The flight to safety will probably continue, at the expense of most EM stock markets and the currencies of countries with large foreign debts.

50. **I sometimes wonder why the US is regarded as a safe haven these days.** After all, American bond markets could decline more as the Fed gets serious about winding down its quantitative easing policies, while US stocks had a very long run already and are not really cheap. So why buy them? But that's how it is, as long as the euro is not yet a viable alternative to the dollar for the investor community.

51. The large depreciation of currencies is welcome news for the countries that rely on exports. They are in a better situation than Greece, Ireland or Portugal which do not have the safety valve of exchange rate devaluations and must rely on so-called internal depreciations, meaning they have to push down wages and inflation. It is good news for their trade partners who are now able to import at a lower cost - which is the equivalent of an increase of their purchasing power and standard of living. **The main problem is that the debt of depreciating countries is mostly denominated in foreign currencies.** Debt service has become a heavier load, and the risk is that in some instances it is too heavy. Countries may become insolvent which could cause another global banking crisis and recession.

52. The countries in question have a share in global GDP of less than 15 per cent. That may look manageable, but as the defaults of Argentina and Lehman Brothers have shown, **even the bankruptcy of a small entity can cause havoc**. The financial world is tightly interconnected and may be hit out of proportion by such an event. While it is impossible to predict what will happen when hell breaks loose one day, the awareness of the IMF and other potential and actual lenders of the risks will probably prevent a chain reaction. Debt can and will be rescheduled. The IMF has substantially increased its fire power in recent years.

53. **Contrarian investors will also come back to these countries once stock markets and exchange rates have fallen to attractive levels.** Emerging markets remain the world's growth engines because they are, as a group, financially sound and have a lot of catching up to do. Investments in infrastructure such as telecoms or transportation systems earn much higher returns than in developed markets. Right now, 15 per cent of the world's population (in the OECD) produce about 50 per cent of total output, 5.7 times more per capita than in developing and emerging countries. This large discrepancy will disappear over time. "Go east, young man!", that's where the opportunities are.

54. **It can be expected that the real GDP of emerging markets will expand by no less than 4½ per cent this year and by almost 5 per cent in 2014. This is in spite of the crises in several of them.** The growth rates for developed markets are 1.0 and 2.0 per cent for the two years. These discrepancies in growth have existed for many years, and will be with us long into the future, they represent well-established long-term trends. In other words, I optimistically propose that the emerging market crisis will be contained and overcome, mostly by market forces.

55. **To sum up, of the three risks listed in the introductory paragraph, only a new oil crisis would be difficult to handle. But long-term interest rates may rise some more. They are held in check by two main factors: low and stable inflation expectations and central**

**banks which will keep policy rates near zero for a considerable time. The world economy is still characterized by disinflation. Risk number 3, a new emerging markets crisis, will not get out of hand – low equity valuations and devalued currencies will make these countries attractive again. And the IMF is well-endowed to give balance-of-payments support.**