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Wermuth's
Investment Outlook

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Wermuth's Investment Outlook

by Dieter Wermuth*

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1. The **main drivers of OECD capital markets** are presently

    - extremely expansionary monetary policies, some of them untested,
    - restrictive fiscal policies, but less ambitious than before,
    - large output gaps and high unemployment
    - a slight acceleration of economic growth,
    - disinflation
    - and profit taking in bond and equity markets (some of which had reached bubbly highs).

2. **Emerging and developing economies** – which in terms of purchasing power parities account for half of the world's GDP - **are generally in better shape**,

    - but growth is noticeably slower than in the first decade of the century,
    - which has put an end to the commodity price boom (oil is still expensive),
    - carry trades are seen to be increasingly risky and are wound down,
    - especially countries with large current account and budget deficits experience capital outflows and depreciating exchange rates, in response to the rising risk that the time of easy money is coming to an end (in the US),
    - as a group, emerging economies remain attractive for financial investors: the catching-up process is based on sound fundamentals and has many years to run; productivity and corporate earnings are rising two to four times faster than in rich countries.

3. **Given the low level of nominal and real interest rates and the fairly rich valuation of equities, investors had once again almost desperately been looking for assets with attractive yields**. They had become less risk adverse. Favorites were property, internet and social networking stocks. The S&P 500 and the DAX index have recently hit all-time highs, though not yet in terms of p/e ratios. Stock markets in almost all advanced economies have been doing very well this year – this includes the markets of countries in the periphery of the euro area. Spreads between corporate and sovereign bonds have narrowed so much that they no longer reflect differences in risk.

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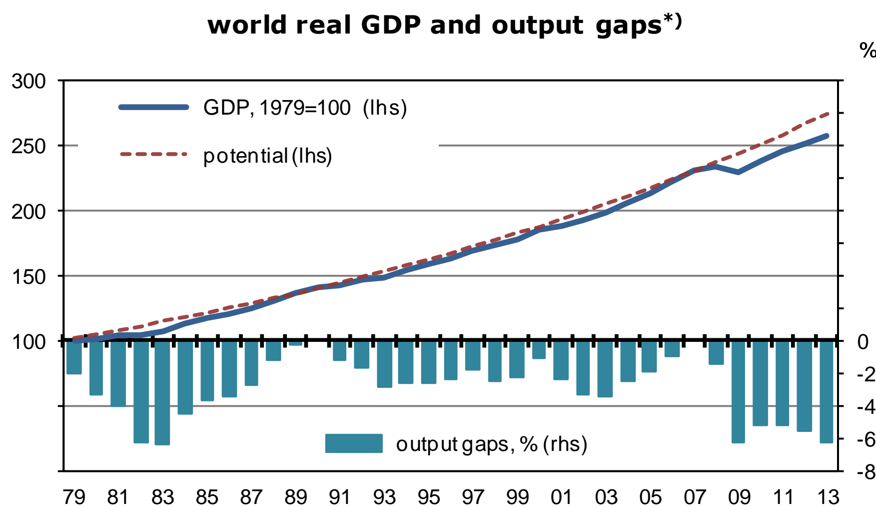
globally it is disinflation – not deflation

4. In its last Economic Outlook the **OECD predicts that the world's real GDP will increase by 3.6 per cent next year, after 2.7 per cent in 2013.** In such a scenario, the gap between actual and potential GDP will stabilize - but it remains huge and continues to exert downward pressure on wages and inflation rates. Fairly strong growth combined with low inflation and therefore the prospect of easy money for some more quarters has convinced investors that the asset price rallies may well continue.



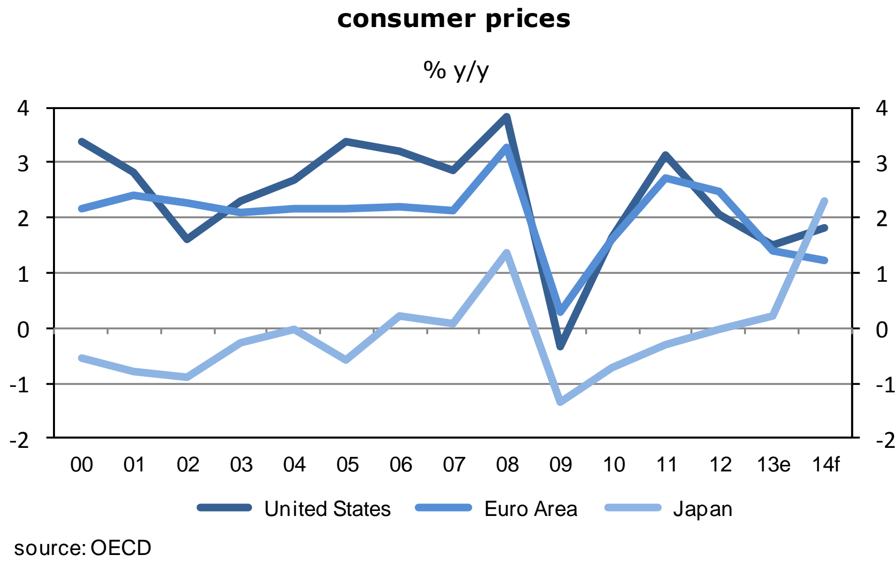
*) at market exchange rates; slope of trendline: 2.9% pa
sources: International Monetary Fund; own calculations

5. **Global inflation is presently running at a rate of about 3 per cent. According to the IMF, inflation was 4 per cent in 2012, and had averaged no less than 10½ per cent in the preceding decade**. These trends may suggest that the world's inflation rate will soon become negative. But this is only a remote risk, mostly because consumer price levels outside the OECD region will continue to rise at rates of 5 to 6 per cent, about four times faster than the OECD average.

6. Why is this? Because **emerging and developing countries** remain in catching-up mode. They are growing two to three times faster than rich countries, and also much faster than their labor forces. This means **productivity, and therefore wages – which in turn drive inflation -, are rising briskly.** As long as the process continues, inflation in that part of the world will remain fairly high (this is known as the Balassa-Samuelson effect). Since unit labor costs are kept in check by productivity gains, it does not mean that the price competitiveness of non-OECD economies will suffer. In fact, their share in world trade continues to rise.

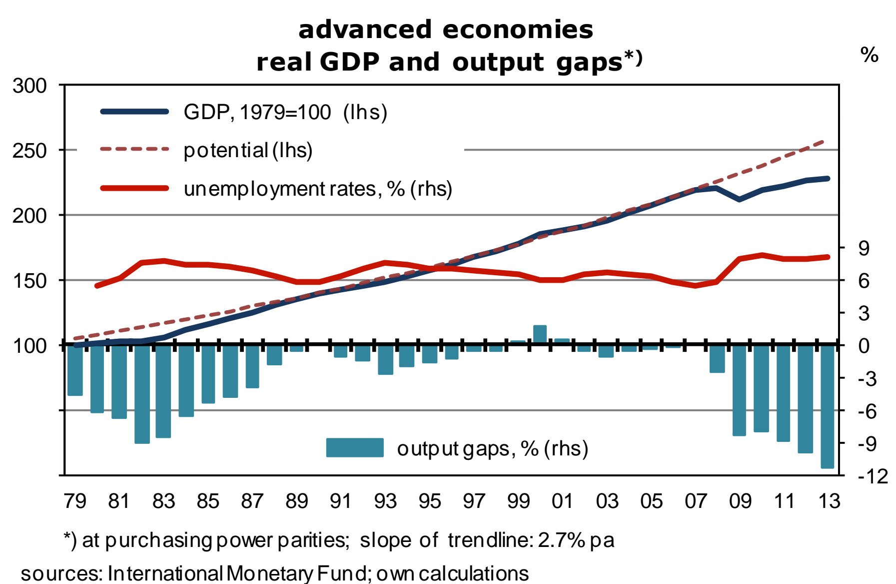
7. **Disinflation may be a global phenomenon, but deflation is only an issue in rich countries.** While wages and consumer prices are sticky, ie do not respond quickly to changes in supply and demand, if capacity utilization remains very low for an extended period of time, inflation will stop at some point, followed by deflation, as in Japan. The **OECD** does not see such a risk. To the contrary, it **expects inflation in the advanced countries to accelerate from 1.5 per cent this year to 1.9 per cent in 2014**. This is actually the target value of central banks such as the Fed or the ECB. Most other analysts are predicting a similar acceleration of inflation.

8. **It reflects the expectation of faster real GDP growth. The US growth rate will rise from 1.7 in 2013 to 2.9 per cent in 2014, the euro area rate from -0.4 to 1.0 per cent. Growth will slow only a little in Japan, from 1.8 to 1.5 per cent**. In the OECD as a whole this year's growth rate of 1.2 per cent will be followed by 2.3 per cent in 2014. The average unemployment rate is supposed to fall from 8.0 to 7.8 per cent. In the real economy, things are moving in the right direction, even though serious downside risks remain. Stronger growth is supposed to lead to a faster increase in price levels.



central banks' forward guidance won't work

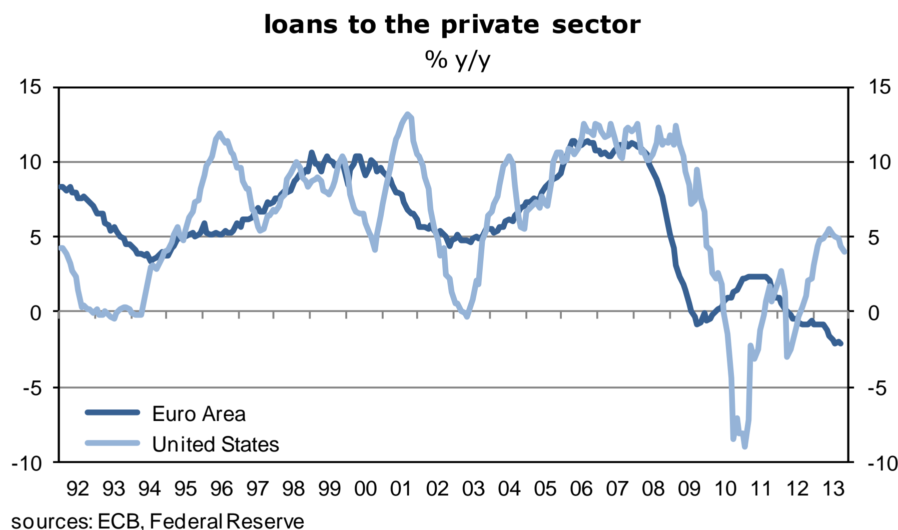
9. **I am not convinced that OECD inflation rates have reached a turning point already**. Here are three reasons: (1) at 7.8 per cent, the average unemployment rate in developed countries would still be close to its decade-long high - this will hold down wage inflation; (2) upstream indices such as the cost of imports, prices of raw materials and producer prices



are mostly below year-ago levels: there is deflation in the pipeline, not inflation; (3) relative to the extrapolated real GDP trend of OECD countries, based on the decade through 2007, today's GDP is about 10 per cent smaller than it could be – this is an indication of the size of the output gap and of the difficulties to raise wages and prices.

10. **If the OECD's growth and inflation forecasts turn out to be accurate, a near-term normalization of policy rates in 2014 looks like a plausible and likely move**. This could trigger a correction of asset markets, though. Since the economic recovery is not yet self-sustaining, an asset price shock is like throwing a wrench into the works. Central banks do not want to raise interest rates at this point. It would amount to a policy shift.

11. They have recently adopted a new tool called **forward guidance, as a substitute for interest rates** which cannot be lowered significantly anymore. In order to stimulate loan demand and thus the economy, they have announced that rates will not be hiked before 2015 even if, by then, inflation is above target. The hope is that market participants take these statements at face value and start borrowing and spending. This is wishful thinking.



12. **If inflation rates do indeed start to rise sometime soon, interest rate expectations would quickly rise as well. For bond and stock markets this would be very bad news**. When some US central bankers began to talk about a reduction of the monthly net bond purchases of $85bn last spring (the so-called tapering), in response to improved economic statistics, they almost caused a market panic. The yields of 10-year Treasuries shot up from 1.63% to 2.99% in just four months. In spite of the Fed's assurances that tapering was by no means the same as raising rates, bond yields have never come close their earlier lows again – they are at 2.86% today.

13. Central banks may be sincere about holding down rates for longer than in comparable cyclical situations of the past, but **once it becomes obvious that the next move of monetary policies will be to tighten, markets will anticipate the event – and crash**. They will crash because today's prices are so elevated, unrealized gains so large, that there will be a scramble to take profits. No one wants to be the last out of the door.

14. It shows that **central banks have lost some degrees of freedom since the outbreak of the financial crisis**. Their room for manoeuver is much smaller than they publicly admit.

15. On the one hand **they have to avoid another large decline of asset values because it could once again destroy the balance sheets of savers and banks**, lead to new rounds of deleveraging, cause recessions and firmly establish deflation. If the general price level falls, central banks have no way to prevent an increase of real interest rates. They would be unable to stimulate the economy with their main tool, the variation of interest rates.

16. On the other hand, they **have become more sensitive about the dangers of asset price bubbles and may not want to repeat past mistakes.** This means they are tempted to tighten policies before bubbles get too big. They are thus clearly in a bind. No matter what they say about keeping policy rates near zero for years to come, they cannot afford such a strategy if asset prices get out of hand.

US household debt repayment well advanced – spending picks up

17. **In the US, the risk of deflation is less than in the euro area.** The main reasons are that **American households have reduced their debt levels considerably faster than European households**, that bank balance sheets are generally in much better shape, and that fiscal policies have been – and are – less restrictive. US banks had been able to sell a big chunk of their mortgage backed securities - which later became non-performing – to the rest of the world. Yield-hungry foreign investors had trusted the asset evaluations of US rating agencies and naively believed that the usual trade-off between risk and return did not apply in this special case.

18. **Another advantage of the US system is the relatively small size of the banking system** – capital markets play a larger role in bringing together savers and borrowers than in the countries of the euro area. In a recent speech in Dublin, ECB Vice-President Vitor Constancio (2 December 2013) has pointed out that the euro area banking sector is 270 per cent of GDP – in the US the ratio is only 72 per cent. Bank loans account for most of household borrowing in euroland.

19. **When the cost of refinancing is close to zero, banks have the incentive to roll over their loans rather than force borrowers to pay up**. Banks can thus avoid showing losses for a long time. The phenomenon has plagued Japan's economy for decades and has contributed to the liquidity trap in which the country remains stuck – and to deflation. It is important that deleveraging, the cleaning-up of households' and firms' balance sheets, does not take too long. Only if debt levels have reached "normal" levels can borrowing and spending take off again. Since euro area households and banks have been dragging their feet as far as deleveraging is concerned, growth continues to disappoint while deflation has become a genuine risk.

20. The OECD has a table in its Outlook (p. 30) that shows the **development of house prices in member countries**: in the US, they have been rising for more than two years by now, after a very steep decline in the years before. The price-to-rent ratio is at a near-normal level of 102, and the price-to-income ratio has fallen to 88. Houses are quite affordable again. No wonder real estate markets have taken off. Deleveraging in this important and volatile segment of the US economy has ended.

housing market conditions		
	price-to-rent ratio *)	price-to-income ratio *)
United States	102	88
Germany	89	83
Ireland	92	92
Greece	82	103
Italy	95	112
Spain	106	107
Netherlands	105	118
France	132	129
Euro area	107	107
United Kingdom	132	122

*) Level relative to long-term average (i.e. average from 1980 or earliest available date to latest available quarter = 100).
source: OECD Economic Outlook, November 2013

euro area deleveraging not yet over

21. **In sharp contrast, euro area house prices continue to fall and the two "affordability indices" are still quite high.** Without Germany - where the stage is set for a housing boom – the indices are still very high and suggest that the sector has to shrink a lot more. In other words, on the basis of the OECD numbers, investors should have a look at US and German real estate but stay away from British, French, Belgian and Dutch real estate. Spanish and Italian markets are getting close to equilibrium.

22. European small and medium-sized firms **(SMEs)** – who employ about 70 per cent of euro area workers - **are also particularly vulnerable to banking sector stress**; loan securitization which could shift risks to non-bank investors remains underdeveloped. It is a serious structural flaw of the euro area economy that prolongates the period of sub-par growth.

23. **Finally, in terms of deflation risks, the US has also not been plagued as much as the euro area by policies aimed at reducing government budget deficits**. Its currency union is well established, including a powerful central Treasury and the world's largest government bond market. There is nothing comparable in the euro area.

24. **The US administration could afford to pursue anti-cyclical fiscal policies, without fear that large deficits might blow up the currency.** Cyclically adjusted, the general government deficit shot to 11.2 per cent of potential GDP in 2009, at the height of the financial crisis, and then declined gradually to 5.4 per cent this year. Looking at the aggregated numbers, **the euro area was much more conservative** – the deficit reached a high of 5.3 per cent in 2009, even though the recession was deeper than in the US, and then came down to just 1.0 per cent in 2013. On present trends, it will have disappeared by 2015 (OECD, p. 240).

25. One way to interpret these data is the following: the **lack of a fiscal union and the constraints of the Maastricht Treaty are holding back growth, keep unemployment near 20 million and risk that disinflation turns into deflation**. Even from a German point of view, the costs of a fiscal union are rather low, or negative, if one takes into account the likelihood that growth would be considerably faster as a result of more determined anti-cyclical fiscal policies. For the euro area as a whole, 1 per cent of additional growth would add €95bn per year to GDP – every year. Some sort of euro area Treasury would do wonders to growth and employment, and reduce the risk of deflation.

26. **So what is the bottom line? Deflation or no deflation? In the US, the risk is rather remote:** employment expands at a robust 200,000 a month, real GDP growth has accelerated to an annualized rate of 3.6 per cent in Q3, the housing market is on the mend, just as the auto market, wage inflation is in the order of 2¼ per cent and thus well above consumer price inflation, fiscal policies are turning less restrictive, short-term interest rates will remain well below 1 per cent even when tapering begins sometime soon, and the dollar is on a slight depreciating trend. All this argues for either stable or rising inflation rates: consumer price inflation is 1 per cent and is likely to move toward the core rate (ex food and energy) of 1.7 per cent. The OECD expects an average headline rate of 1.8 per cent in 2014. I agree.

27. **Since full employment is a long way off, though, this does not mean that the Fed will raise rates.** It may scale down the growth rate of its balance sheet – not least to prevent stock and house prices to get out of hand – but there is no reason to raise policy rates next year already. Dollar bonds will suffer in the near term as the Fed withdraws as a major buyer, but the spread between short and long term interest rates cannot widen indefinitely. This would require inflation expectations to rise well above 2 per cent. I cannot see this yet.

28. In any case, **near-term, dollar bonds are not the place to be. Investors should increase the share of cash in their dollar portfolios.** The US economy will not relapse into recession given its momentum, the advanced stage of deleveraging, the strong monetary stimulus and the smaller restrictive effect of fiscal policies going forward. When short-term interest rates either stay where they are or will go up, cash is the default option.

deflation still a risk in the euro area

29. **In the euro area, there is clearly a whiff of deflation in the air, though.** Real GDP growth has been negative this year so that the wide output gap got even wider. Unemployment is extremely high and not really coming down, even in the most optimistic forecasts. Deleveraging of households and banks has not ended – credit demand of the private keeps shrinking, and the euro seems to appreciate.

30. **The ECB, in its new macroeconomic staff projections, expects an average inflation rate of 1.1 per cent in 2014, up from 0.9 per cent y/y in November**. This is an acceleration rather than a deceleration of inflation. I think the outcome will be a lot lower than 1.1 per cent, perhaps 0.5 per cent. While even this is not deflation, the euro area is getting dangerously close to it.

31. The ECB is aware of the risk – because the economic recovery is by no means self-sustaining - and will therefore keep rates down for a long time. **Rather than shrinking its balance sheet, as the Fed is planning to do, it will probably try to expand it again.** It had

contracted quite a bit over the past year. All this implies that German government bond yields will rise only moderately in the near term, pulled up by Treasury yields, but will soon come down again. The spread vis-à-vis Treasury yields is bound to widen.

banking union will change the rules of the game for investors

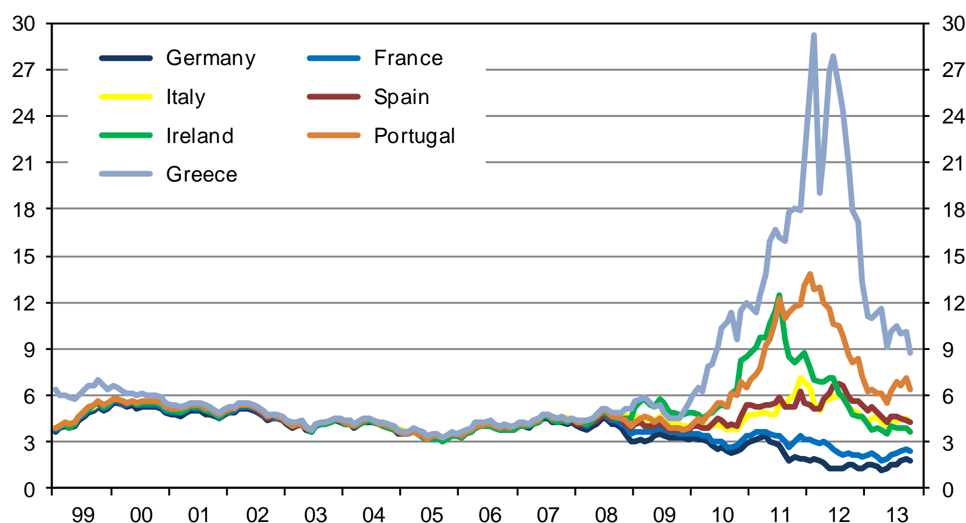
32. To be sure, **euro area capital markets remain fragmented**. The focus on Germany hides the fact that there is still a wide disparity in growth, unemployment, government finances, interest rates and inflation. The cross-border credit allocation is dysfunctional. But the **banking union is coming in great and transformative strides ever since it was decided in June 2012 to entrust the ECB with area-wide bank supervision.**

33. After concluding, by next fall, its **12-month comprehensive assessment of the asset quality of about 130 banks** – which account for 85 per cent of all banking assets – it will start its work. Bank supervision will be standardized by then, and national supervisors will have to report to the ECB. The political hurdles are still high. Powerful national champions are under attack in a truly unified banking market and cannot expect preferential treatment to last. Or so I hope. The process has so much momentum, and the costs of stopping it halfway would be so high, that the chances of successfully implementing the Single Supervisory Mechanism (SSM) are pretty good.

34. After common bank supervision, **far-reaching decisions about the organization of bank resolution and deposit insurance will follow almost automatically** in coming years. A common monetary policy and a common currency are not possible without a full-fledged banking union. The euro area has learned this the hard way.

government bond yields

- 10-years, percent, monthly averages -



source: European Central Bank

35. **For investors, several conclusions can be drawn if I am right about the further integration of euro area capital markets**:

- Markets that had been considered too risky will perform best. Think Greece, Ireland or Portugal. As bond yields will converge further it pays to short Germany, Finland and Austria and be long most others.
- Average bond yields will fall, ceteris paribus, as foreign safe haven demand for euro bonds increases.
- Once it is recognized that the probability of a breakdown of the currency union is close to zero, attention will turn to the sound fiscal and external fundamentals of the euro: it will appreciate in nominal and most likely also in real terms.
- There will be a consolidation of the banking sector. The ECB will push for that. The euro area is overbanked; end users pay too much for financial services.
- Stock markets will consolidate as well – there are too many stock exchanges -, accompanied by a wave of cross-border corporate mergers. This will lead to a reduction of average price-to-earnings ratios and thus lift stock prices to levels that are comparable with US standards. I would estimate that this effect will raise stock prices by about 10 per cent. Put differently, risk premia will no longer so much higher than American ones.
- And so on. Some of the effects will come quickly, others will take more time.

stock markets: new favorites

36. If there is a question that keeps portfolio managers up at night, it is **whether stock markets have still some upside potential**. In general, 2014 corporate earnings in those OECD markets that had not been affected by the euro crisis, or even benefited from it, are expected to increase by between 10 and 15 per cent compared to 2013. The pick-up of economic growth is accompanied by a more than proportional increase of profits. This is typical for a recovery period. Workers are still in a weak negotiating position and not able to increase their share in national income.

37. But stock markets had a very good run since March 2009 already. This, of course, had been the time when investors had been most depressed, but **even in the past two years, markets have continued to race ahead briskly.** The S&P 500 has been up 49 per cent, the German DAX 55 per cent, and the Nikkei 225 no less than 81 per cent. These are bubbly numbers. A look at the **risk premia** confirms the impression that these three markets are pretty expensive, in particular the US where the premium has reached a low of 4.2 percentage points (Germany 5.8, Japan 4.9). The flight to American safety, liquidity and economic strength has driven the US index to levels where the air is thin.

38. Now that the euro is increasingly supported by solid institutions and the ECB's declared intention "to do whatever it takes to stabilize the euro" it **may be time to consider investing in neglected markets such as Italy and Spain, or France.** They are all trading far below pre-crisis highs. Italian and Spanish firms are expected to increase profits by 20 and 30 per cent, respectively, next year. Analysts are predicting that Irish and Portuguese earnings will rise by 100 to close to 300 per cent between this year and next - from a very low level, of course.

39. **Stock markets in emerging economies have been the wallflowers of the season.** Mexico, Brazil, Russia, Turkey, China (CSI 300), Thailand and Indonesia are all down since the

beginning of the year and trade far below previous highs. Korea has been flat. In light of fairly robust growth prospects and generally sound fundamentals, the withdrawal of US, European and Japanese money from these markets is not really plausible.

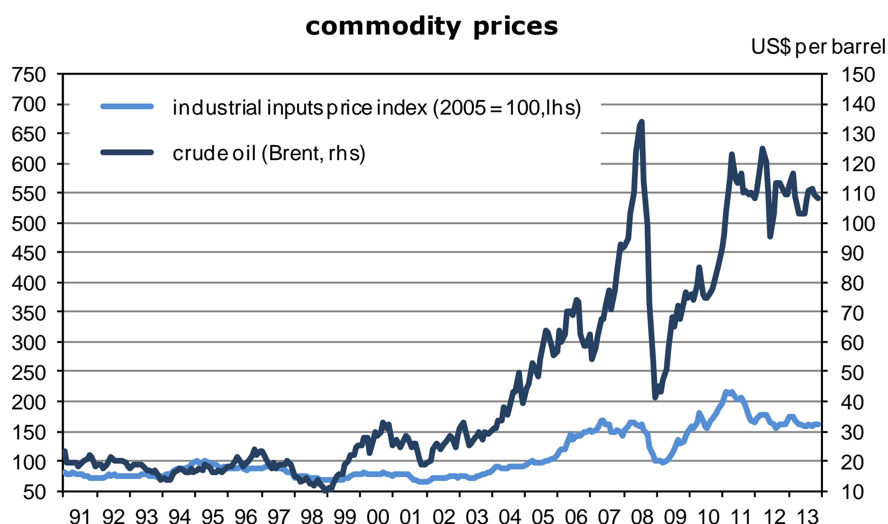
40. True, growth is not as giddy as it used to be but the competitive advantage in terms of labor costs and productivity gains has not gone away. Most importantly, the process of catching up with OECD countries has decades to run. Just one example: assuming that China's nominal per capita GDP will rise by 10 per cent year after year and that the exchange remains stable, it will take 27 years before it is on par with Germany's (where I assume a growth rate of 2½ per cent). In India, it will take more than half a century. In other words, **this may be the time for contrarian financial investors to lay the foundation for superior long-term performance.**

commodity prices remain under pressure

41. To conclude, let me make **a few remarks about commodities and currencies**. As to metals and food, dollar prices are down about 15 per cent from one year ago. In euro terms, it is more like minus 20 per cent. Once again, reality has caught with the hype about the earth's limited resources, peak production and ever rising absolute and relative prices of commodities. These are unsophisticated products whose output reacts strongly to changes in demand and supply.

42. **High prices reduce demand**; users tend to switch to cheaper substitutes and to increase resource efficiency. These effects are often reinforced by recessions which tend to result from commodity price booms. On the supply side, **high prices lead to more output**, more spending on resources and technology, and the exploitation of marginal fields.

43. What I want to say here: today's elevated prices of raw materials, measured in standard deviations from trend, usually bode ill for future spot prices. Markets are mostly very volatile – unless producers collude and create a cartel that keeps members under tight control. Cartels are forbidden, though, unless they cannot be forbidden, like OPEC.

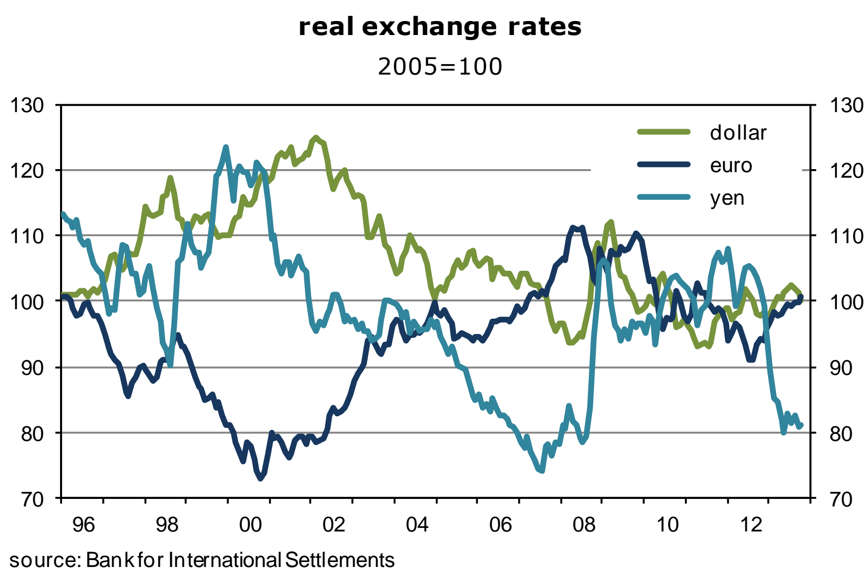


44. This brings me to **the oil price. I am at a loss if I had to explain why it is holding up so well.** I consider it to be about 50 per cent above its equilibrium, no matter how this is calculated. All oil executives and most analysts expect falling prices, if by a smaller margin than what I consider is needed for normalization. Reduced political tensions in the Gulf, a big increase in US production, the on-going replacement of hydro-carbons by renewables, a fairly weak expansion of the world economy all argue for downward pressures on prices.

45. On the other hand, the **cartel seems to hold together well**, with Saudi Arabia as the swing producer which cuts output opportunistically when revenue-maximizing poorer countries extract more from the ground than their quotas. There could also be a **structural element here: growth in emerging economies** – which is driving global growth - is energy intensive. Cars, houses, air conditioning, travelling, or commuting to work all need a lot of oil products as consumption patterns more and more resemble those in the rich countries. Hard to say. I know that commodity price bubbles often last longer than investors can afford to short, but in the end bubbles will always pop. I wish I could be more precise than that. My track record in predicting the gold price gives me some confidence that my reasoning cannot be all wrong – meaning that the oil price must fall.

yen continues to be weak, euro is getting too strong

46. As to currencies, the most remarkable change has been the **near-collapse of the yen.** Japan has embarked on an all-out assault on deflation which not only means government budget deficits in the order of 10 per cent of GDP in 2013 but an extremely aggressive expansion of the Bank of Japan's balance sheet. A side effect is the depreciation of the yen which borders on the unilateral declaration of a currency war. The other countries do not complain loudly because they figure that if Japan can finally escape its liquidity trap the own loss of competitiveness is a price worth paying. Since the success of "Abenomics" is by no means assured – note that the yield of the 10-year bond is only 0.65 per cent – **forecasting further yen weakness is a fairly safe bet**. It makes sense to borrow yen and invest the proceeds in other markets, including Japan's own stock market.



source: Bank for International Settlements

47. **The dollar refuses to appreciate against European currencies** as much as analysts in London and New York continue to predict. In fact, it is depreciating. I think it will continue to do so, simply because there is so much of it in foreign hands. Profit taking, diversifying into euro, plans to stop intervening (China!) and very low returns on dollar assets are a potentially explosive mix.

48. For European policy makers, **the appreciation of the euro is not really welcome.** There is no need to import disinflation when consumer price inflation is already so dangerously low. As I have shown above, the coming banking union will dispel most, if not all doubts about the future of the euro. Investors will therefore put more weight on the positive fiscal and current account fundamentals of the euro.

49. The **OECD expects that net exports will positively contribute to euro area real GDP growth** (of 1 per cent) in 2014. This is presumably based on the assumption that the region's price competitiveness will improve or at least not deteriorate, ie, on a weak euro. This could also be wishful thinking.

50. One thing is certain: **if the euro continues to strengthen, the ECB will pull all stops to stimulate domestic demand.** Will it include buying dollars and yen? Theoretically yes, but in practice no. The euro area is too large. A currency war is the last thing the world economy needs. Central banks may try to cooperate more closely on the exchange rate front and provide some guidance about where they think bilateral rates should be, like in the early years of the floating exchange rate regime.

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