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Wermuth's
Investment Outlook

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February 27, 2014

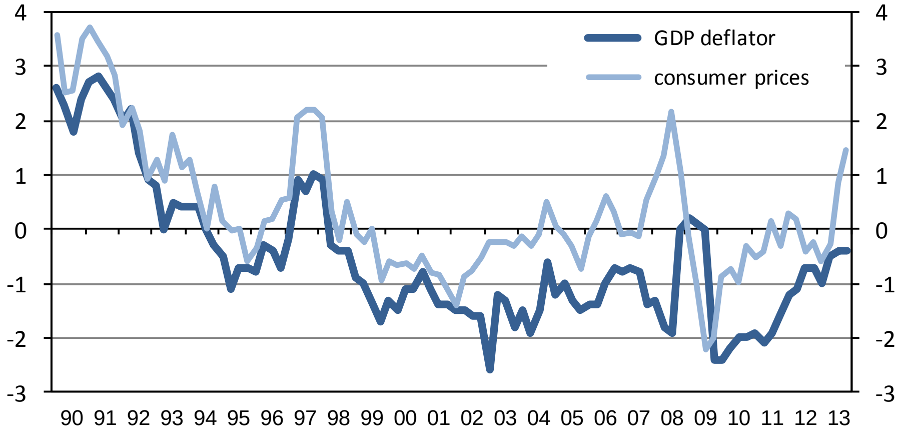
Central banks want higher inflation – but disinflation continues

by Dieter Wermuth*

1. Investors, traders, analysts, the media, the general public, central bankers and, last but not least, myself are **convinced that disinflation is a mega trend**, especially in the rich part of the world. Many market participants are afraid that **disinflation could be a prelude to deflation**, a situation where price levels fall for several years.

2. **It last happened in Japan**: in the 14-year period 1999 to 2012 consumer prices declined at an average annual rate of 0.3 per cent, the broader GDP deflator at a rate of 1.3. (I use 1999 rather than, say, 1994 as start date because the massive increase of the sales tax in April 1997 had artificially pushed up inflation in 1997 and 1998). As in America's Great Depression of the thirties, deflation is associated with very low economic growth: in Japan, real GDP had increased at an average rate of just 0.8 per cent in the 14 years to 2012 – growth had been 4.5 per cent between 1978 and 1991.

Japan in deflation
% y/y



sources: Ministry of Internal Affairs and Communications, Cabinet Office

investment strategies in an era of disinflation

3. Today, the risk of deflation is generally regarded to be more serious than the risk of a new acceleration of inflation. The problem may be that almost everybody is of the same opinion. Such a herd mentality inevitably creates bubbles. **This time the risk is that we might get bubbles in reverse.** People are increasingly betting on low or negative inflation and extremely expansionary monetary policies - and have positioned themselves accordingly.

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4. But what about all this money printing, the massive expansion of central bank balance sheets resulting from the purchase of government bonds (in the US, in Japan) or from the flooding of the banking sector with long-term loans at near-zero interest rates (ECB)? **Won't this lead to hyperinflation at some point?**

5. Going by the very low growth rates of monetary aggregates such as M3 or lending to the private sector, **the transmission of the massive stimulus to the real economy does not work right now.** Important economic agents are still in debt reduction mode and unwilling to borrow more to spend more. They save too much.

6. In other words, monetary policies fail to stimulate the demand for goods and services in a meaningful way. Rates of capacity utilization remain depressed, and the risk of an acceleration of inflation is small. Since the understanding of today's economic dynamics is quite limited in the profession and among policy makers, **I cannot exclude that in the end we do get hyperinflation. But I don't think we are near that point yet.**

7. **The preferred strategies in a world of disinflation and deflation are holding cash and buying high-grade government bonds or equities of dividend paying monopolists in mature markets**. Money can also be made by entering short positions in assets that are considered to be inflation hedges, ie by doing the opposite of what one would recommend when the threat was inflation: think shorts in real estate, commodities, especially gold, bonds linked to inflation indices, growth stocks and safe haven currencies. If it is not possible to go short, these assets should simply be sold.

what to do when disinflation turns into inflation again

8. Once a sufficiently large number of analysts and market participants are convinced that inflation will be back and that it will only be a matter of time before central banks tighten policies again, **everybody will scramble for the exit**, trying to lock in profits and change sides. There was whiff of that in the air when the Fed indicated last spring that they were thinking about scaling down the volume of their bond purchasing program. For a few weeks it looked as if the trend had turned.

9. Should this happen, the strategy would be to **sell US Treasuries, Bunds, Japanese and Swiss government bonds and low-volatility/high dividend stocks, and use cash holdings and credit lines to buy real estate, Swiss francs, futures on gold and commodity indices, inflation linkers and growth stocks**. Perhaps it would also be the right moment to get a new car.

10. This is all pretty straightforward. The **question is how close we are to such a tipping point when the herd decides that enough is enough** and starts heading in the opposite direction. The answer to that is not straightforward at all, but I remain convinced that disinflation will continue to be with us for some time: costs in OECD countries, and many countries beyond, are either rising very slowly, or falling. Because the deleveraging of government, bank and household balance sheets is still going on, demand for goods and services will expand only slowly, hardly any faster than potential GDP – output gaps remain large.

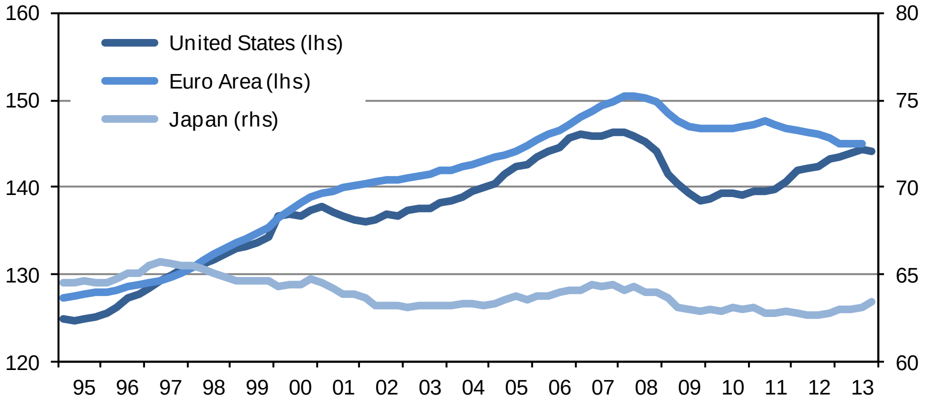
11. Let us look in some detail at cost developments. In an open economy, total costs are determined by aggregating the costs of labor, capital and imports, the inputs for the production process.

labor cost inflation will remain subdued

12. Labor costs usually account for something like two thirds of total costs and are therefore the most important factor. In general, **consumer price inflation will not happen without wage inflation.** Since productivity, defined as output per working hour, rises fairly steadily along a trend line of (in the case of Germany) 1.2 per cent annually, wage inflation in that order would leave unit labor costs unchanged. If a consumer price inflation rate of about 2 per cent is considered to be price stability, as in most OECD countries, wage increases in the order of 3 per cent are sort of neutral, ie in terms of their impact on target inflation.

employment*)

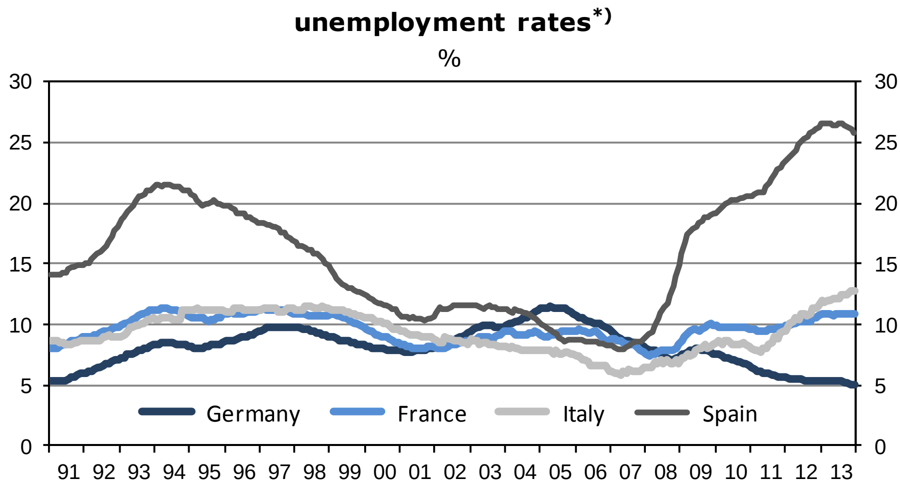
million persons



*) seasonally adjusted

sources: Eurostat, Federal Reserve, MIAC-Statistics Bureau

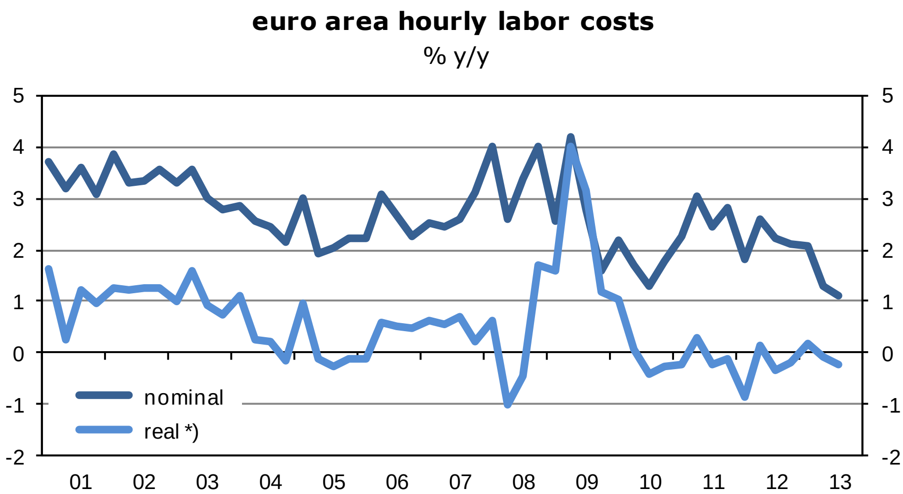
13. **In the euro area, wage inflation continues to be held down by poor labor market conditions.** Employment rose steeply between early 1999, after the introduction of the euro, and the first quarter of 2008, shortly before the deepest post-war recession on record (from 133.4m to 150.5m, +1.3% per year). It has since fallen to 145.0m. The unemployment rate is stuck at around 12 per cent. Youth unemployment is several times higher, especially in the countries of the so-called periphery such as Greece, Portugal, Spain and Italy, but also in France (24%). It is the most serious economic and social problem of the euro area and a time bomb. During the boom years, too many resources had been devoted to construction and services that catered primarily to domestic demand, triggered by the dramatic fall of real interest rates and capital inflows. Many young people had simply learned the wrong things – or nothing at all in those easy days. In much of the euro area demand and supply of labor are now out of synch - which is one reason why it so difficult to return to previous rates of economic growth.



*) unemployment according to ILO definition; seasonally adjusted

source: Eurostat

14. It is not surprising that the compensation per hour had been just 1.6 % y/y in the euro area as a whole in Q3, while **labor cost indices - which include employers' social contributions – were up only 1.0% y/y.** These are the most recent statistics available. Wage inflation rates are still declining. The situation in Germany is better than in the rest of the area, with unemployment at 6.8% and employment rising at a rate of 0.6% y/y: hourly wages are up 2.3% y/y. This is the main reason why German inflation is somewhat higher than the euro area average (1.2 vs. 0.8% y/y).



*) CPI-deflated

source: Eurostat; own calculations

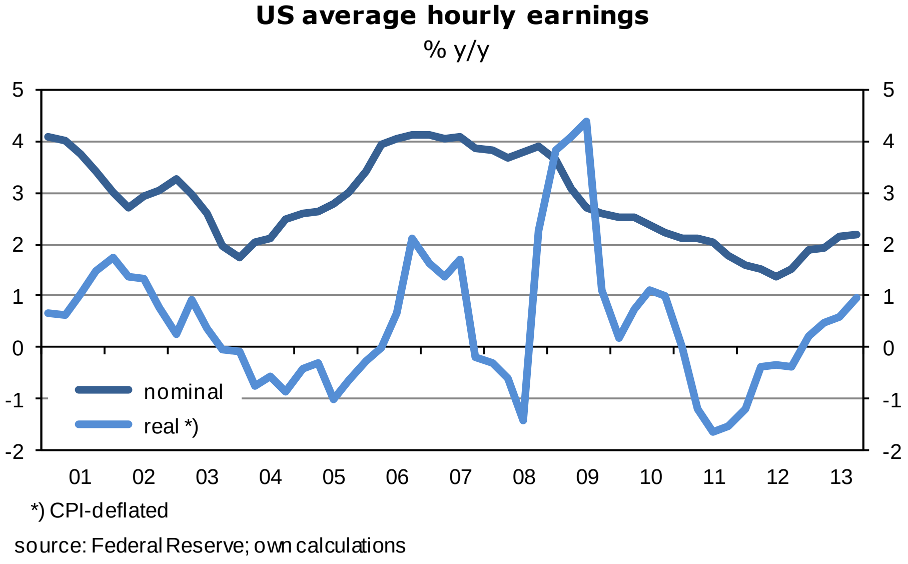
15. **Overall, euro area wage inflation is so moderate**, and the negotiating power of workers so weak, that labor costs will continue to contribute to disinflation, especially if productivity growth rates return back to normal one day.

16. **In the US, the recovery of the labor market is well on its way** (see graph above): the set-back of the 2008/2009 recession was more severe than in the euro area, but there has been a marked recovery afterwards. This is in stark contrast to developments in the euro area

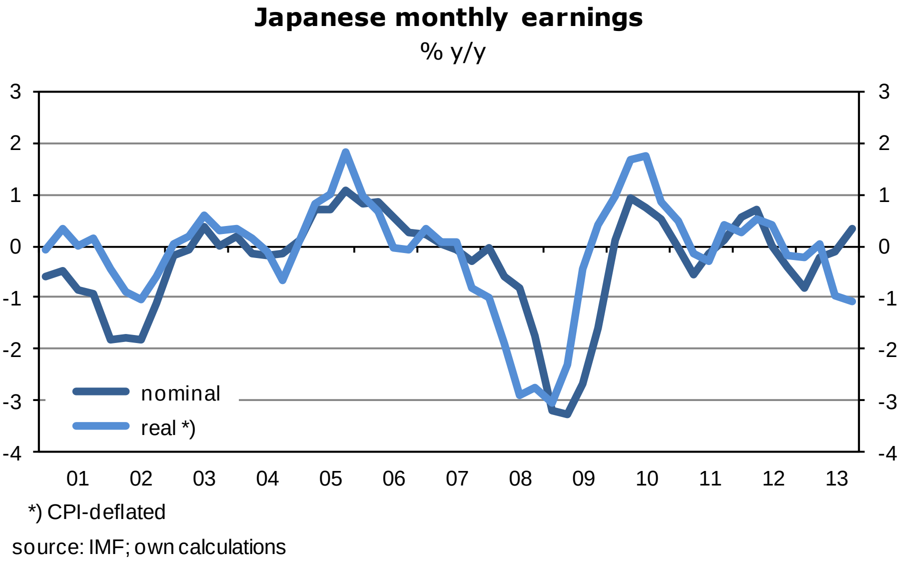
where employment has not even begun to pick up. American firms like to fire workers quickly but they also hire more quickly when the outlook improves.

17. **Even so, there is a lot of slack in the US labor market.** The rapid decline of the unemployment rate from 10.0 in October 2009 to 6.6 per cent this January is deceiving. Millions of discouraged workers are no longer counted as unemployed. The so-called participation rate remains depressed, and actual employment is still almost 10 million below trend.

18. **This keeps US wage inflation in check**. Hourly wages have been rising at a rate of about 2 per cent for several years while inflation rates are on a downtrend and have reached 1.5% y/y. The key labor cost indicator – unit labor costs – is in the order of 1 per cent. It thus helps to lower consumer price inflation and contributes to further disinflation.



19. In response to expansionary Abenomic policies, **Japanese labor market conditions have improved somewhat** since early 2013, but the labor market participation rate (at 59.3%) remains well below "normal"; overall employment (63m) is still about 3m less than at the last peak in 1997. This suggests a lot of hidden unemployment. Declining real wages are a sign of excess labor supply – in the past 13 years these were down by an average rate of 0.1 per cent. Think of it: **13 years of stagnating real wages**! In this period, average real GDP growth was 0.8 per cent. Non-labor incomes have obviously increased considerably, a phenomenon that has been observed in all advanced economies.



20. **To draw a bottom line under the labor cost analysis of the US, the euro area and Japan** - which together account for 38 per cent of global GDP - it is evident that disinflationary effects are prevailing, especially if the recovery of productivity which is now underway starts to kick in again. This either pushes down unit labor costs, or keeps them in check. In the US whose labor market is the strongest of the three economies, the increase in output per hour (1.7% y/y) is only marginally less than that of hourly earnings (1.9% y/y in January).

money market rates will stay close to zero for the foreseeable future

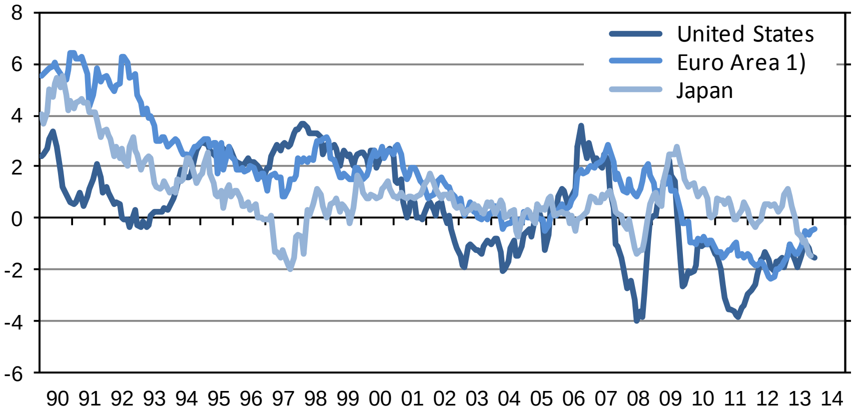
21. **Turning to the cost of capital as the second determinant of an economy's overall costs**, there are signs that the Fed is taking away the punch bowl – ie, become less expansionary - , but the ECB and the Bank of Japan are still on a very different track: stimulating policies will continue as long as money supply and lending to the private sector are increasing at worryingly low rates. Inflation in these two economies is an even more important worry. In the euro area, consumer price inflation had been 0.8% y/y in January; the first estimate for February is just 0.6 per cent. In Japan the January headline number has probably been 1.3%, while core inflation seems to be stuck at 0.7% - much too low for the taste of the central bank which desperately tries to implant a new inflation mentality.

22. **The priority of all three central banks is to raise actual inflation rates and get away from the ominous zero per cent fault line. Monetary stimulus will persist in the euro area and Japan, but also in the US**.

23. **Money market rates are one component of the cost of capital – many firms use floating rate loans to fund their short-term expenses**. As the graph (p. 7) shows, real rates have been negative for several years in the US and the euro area; in Japan real rates are negative since the summer of 2013. In other words, borrowers are being paid to borrow. Such a situation can last for some more time. The three central bank governors have all made clear that they won't raise rates even if – as in the US – the unemployment rate falls faster than expected and below the original target (of 6 ½%).

real short-term interest rates*)

%



*) 3m money market rate minus annual CPI inflation rate - 1) until 1998 Germany
sources: Federal Reserve, Bundesbank, Bank of Japan; own calculations

24. Economies are not yet on a self-sustaining growth trajectory and thus need monetary life support. One at least occasionally **powerful tool is to keep or widen the difference between short and long term interest rates, ie to provide an incentive for banks to borrow short and invest long**. It is also a way to help banks to earn profits and to restore their equity base and their ability to lend. Since long rates have fallen so much, reflecting very low inflation expectations, central banks are stuck to keep policy rates at rock bottom levels. They cannot afford to shrink the difference (flatten the yield curve). The ECB is even considering to introduce a negative rate on the deposit facility for banks, and to cut the main refinancing rate further (presently 0.25%). The American and Japanese policy rates are very close to zero already. But the downside potential for money market rates is clearly very limited by now – they will be more or less flat going forward.

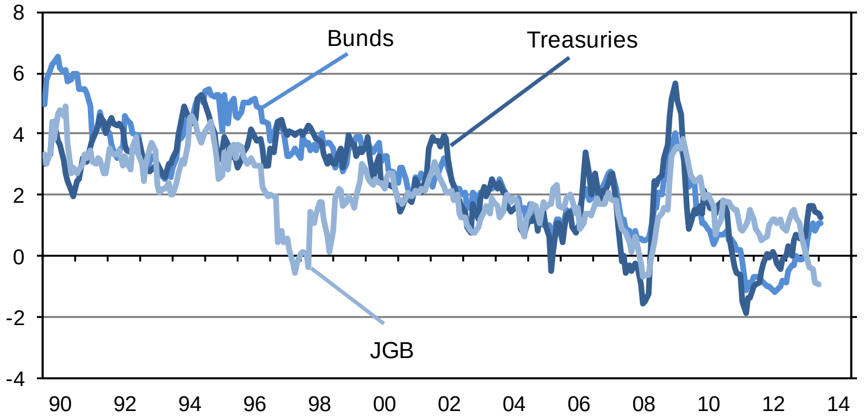
25. Incidentally, in this connection, the so-called quantitative easing is a double-edged sword: by buying long-duration bonds in order to lower bond yields and thus stimulate long-term borrowing and capital spending the central banks counterproductively flatten the yield curve – this has restrictive effects on economic activity.

long-term dollar and yen rates will rise somewhat, euro rates with downside potential

26. **The cost of long-term debt is not close to its all-time low, but still very low historically, in both nominal and real terms.** Rates at the long end of the yield curve are considerably more volatile than rates on short-term debt – committing funds for ten years or more at fixed rates implies considerable risks as well as opportunities. Borrowers and investors are therefore very sensitive to changes, perceived and actual, of monetary policies, inflation rates, exchange rates or government budgets that could have an impact on the market values of their long-term liabilities and assets.

real long-term interest rates*)

%



*) 10y government bond yield minus annual CPI inflation rate
sources: Deutsche Bundesbank, Federal Reserve, ECB; own calculations

27. **Long-term interest rates will go up if the Fed tapers its quantitative easing too aggressively.** Until not long ago, the US central bank was buying $85bn (net) of Treasuries and bonds of state-owned mortgage providers every month. This was the equivalent of 6 per cent of nominal GDP (the government budget deficit is "only" about 4 per cent of GDP). According to consensus estimates, net purchases will be down to zero sometime this fall. Dollar bond yields will then mostly be driven by (short-term) policy rates, inflation expectations and cross-border capital flows, no longer by bond market interventions of the Fed.

28. **Euro area and Japanese bond yields usually move in the same direction as US yields**. One of the reasons: if the value of dollar bonds falls – because yields go up – investors tend to sell other (European and Japanese) bonds to re-establish the old portfolio weights, which in turn drives up their yields as well.

29. **So what's the outlook for US Treasuries? Yields will more likely rise than fall**: the economy continues to expand, if not any longer at the impressive annualized real GDP growth rate of almost 3 ¾ per cent of last year's second half, employment is recovering steadily, and the Fed reduces its support of the long end of the curve. But **any increase of yields will be kept in check by very low money market rates:** while 10-year yields are 2.71%, 3-month LIBOR is just 0.23%. It remains very tempting to borrow short and invest long.

30. The **situation in the euro area** is similar at the short end: 3-month LIBOR (0.26%) is almost exactly the same as dollar LIBOR. But average European bond yields are considerably lower than in the US; using the 2023 bond of the EFSF (the European Financial Stability Fund) as a proxy for the average, the long end is at 1.97% today; Germany's 10-year Bund yields only 1.65%. This partly reflects the fact that the (aggregated) fiscal deficit is smaller than in the US, partly the larger output gap.

31. **I do not expect that German yields will fall much more** even though this cannot be excluded – on May 2 last year they had fallen to 1.17%, an all-time low. But the bond markets of Ireland, Spain, Italy, Portugal and Greece will probably continue to rally and pull down the average yield of euro area government bonds.

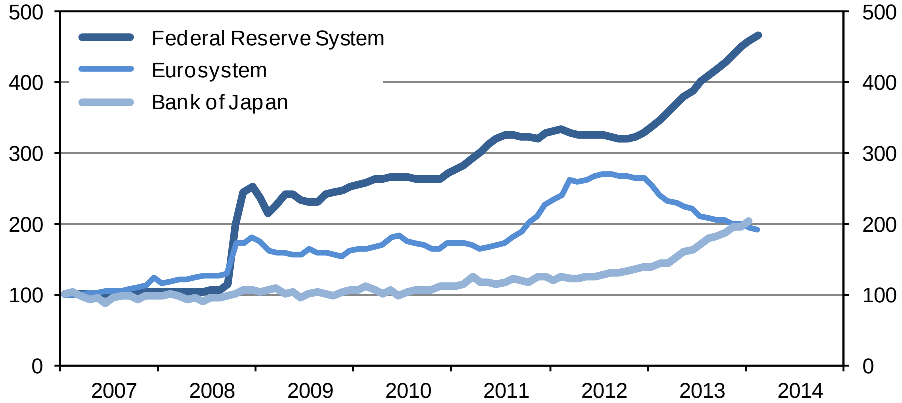
32. **Once-skeptical investors who had been betting on a break-up of the euro have thrown in their towels by now.** The determination of the ECB to do whatever it takes to prevent such a break-up, the visible improvement of current accounts and government budgets plus very low inflation rates in the countries of the so-called periphery, and the significant progress toward a genuine banking union based on mutual control and solidarity have made it increasingly probable that the euro crisis will not return. This means that corporate bond markets which get their signals from the bigger government market will also do fairly well. Euro area corporates are generally in pretty good financial shape. **The rally of the euro denominated corporate bond markets will probably continue, pushing down the cost of long-term external funds.**

33. **This can also happen in yen markets but nominal bond yields there are already extremely low** (0.58% for 10-year JGBs), and thus negative in real terms. If the Bank of Japan can help it, yields will not fall further. They are actually already close to last year's low of 0.44%. Compared to a 3-month yen LIBOR rate of 0.14% they are certainly not very attractive for investors who consider to fund purchases with short-term money (also called carry trades). **The Bank of Japan is actually in a dilemma**: while it would prefer inflation expectations and bond yields to rise, it also intervenes heavily in government bond markets and thus pushes yields down. It routinely buys up a large chunk of the government budget deficit (which is 8 per cent of GDP).

34. Hard to say where Japanese long-term interest rates are heading. The economy is clearly on a recovery path, deflation has been replaced by positive and rising inflation (CPI in 2014 may be 2½ % y/y, if mostly because of the coming VAT hike), and Abenomics is still in full swing. **Bottom line: long-term yen interest rates will probably rise somewhat. The emphasis is on "somewhat" – in real terms they will stay negative for some time.**

central bank balance sheets*)

Jan. 2007 = 100



*) total assets

sources: Federal Reserve, ECB, Bank of Japan

35. To aggregate the results of the above analysis of long-term yields in the three economies I am looking at, it is more likely than not that they will not move much. There is some minor upside potential in the US and in Japan, but in the euro area the trend is sideways or slightly down.

equities are not cheap anymore

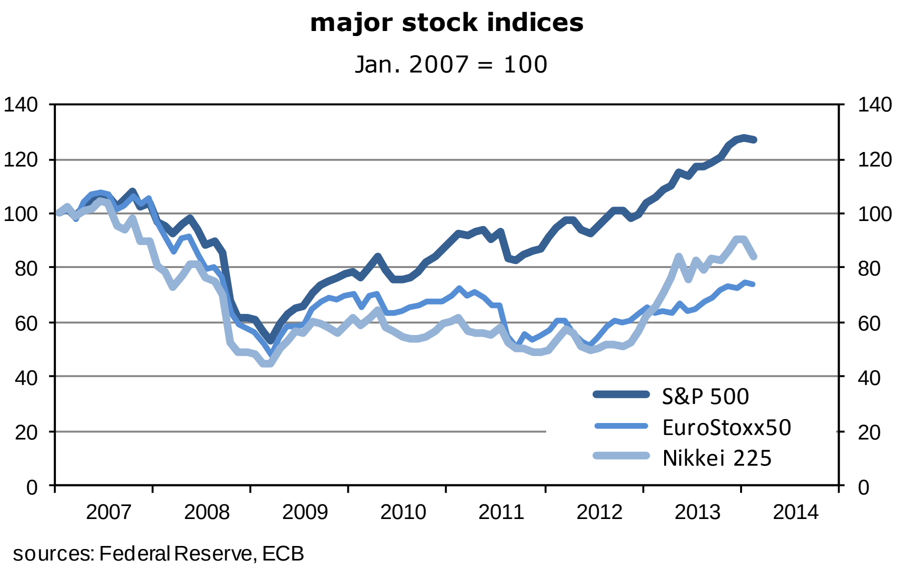
36. **The next and last component of capital costs is equities** – if stock prices rise, funding via issuing shares gets cheaper, and vice versa. To give an example: the recent price explosion of **Tesla stocks** has increased the firm's market capitalization by billions of dollars in a few days. In mid-January the Palo Alto producer of electric cars was worth $16.5bn, today, one month and a half later, the market value has increased to $30.4bn. Without making any profits yet, without paying any dividend, Tesla's cost of equity is negative, and the owners are not lacking the means to launch large capital spending programs (for batteries).

37. **So where are stock markets in the three economies heading? After some very good years, stock markets in rich countries will probably mark time in 2014, or decline. A correction in the order of 10 per cent is more likely than another double digit increase**. Stock prices have raced ahead much faster than corporate earnings, a sign of investors' positive expectations. Output is finally expanding at a faster clip than in 2012 and 2013 when real GDP growth in the advanced countries averaged just 1.3 per cent. Given that countries are still in the recovery process after the deepest recession in decades, these have been disappointing numbers. Capacity utilization rates and employment levels remain far below normal, including the US, the euro area and Japan.

38. In any case, growth is accelerating. The present consensus calls for an average real GDP growth rate in the rich countries of 2.1 per cent in 2014. The largest swing is taking place in the euro area: after GDP had declined by an average of 0.5 per cent in the last two years, it will probably increase at a rate of 1.2 per cent in 2014. The US goes from an average of 2.4 per cent in 2012/2013 to 2.8 per cent this year, while Japan slows from 1.6 to 1.4 per cent. These are not stellar figures, but **profits will nonetheless increase quite briskly**: as I have shown above, labor costs are rising only moderately. In the early stages of a recovery workers continue to be impressed by persistently poor labor market conditions. Profits are also boosted by productivity gains. These are particularly large when expanding output fills previously idle capacities.

39. **While this is good news for stock markets, valuations are rich**. Lots of positive developments have been priced in, and more than that, it seems to me. Trailing price-to-earnings ratios are in the neighborhood of 17 for American and euro area stock markets, and at 20½ for the Nikkei 225. All three are roughly one fifth above long-term averages.

40. **Robert Shiller's valuation approach leads to the same conclusion**, except that the overvaluation is even more dramatic. In his concept, the "e" in "p/e" is not the most recent earnings-per-share statistic but rather the average of the past ten years, about the length of a full business cycle. According to the Bank Credit Analyst, a Canadian think tank, "US stocks currently trade 58% above the median Shiller P/E since 1881, but only 27% above the median Shiller P/E since 1960."



41. There is never just one plausible valuation measure. The **risk premium** is one of the alternatives. It is the difference between the earnings yield of a stock (or a market index) and the real riskless rate (of a high-grade long-term government bond). The earnings yield is the inverse of the p/e ratio – if the latter is 17, the inverse is 1/17, or 5.9%. Since real bond yields are so low – and even negative in the case of Japan – the risk premia are ceteris paribus fairly high: about 4.7 for the S&P 500 and the Euro Stoxx, and 5.6 for the Nikkei 225. In a disinflationary environment with expansionary monetary policies and rock-bottom real bond yields, relatively high risk premia can be justified – and **high p/e ratios do thus not necessarily suggest that stock markets are overpriced.**

42. The problem is, the closer you look the more answers you get. Irritatingly, they often point in different directions. I am conservative and try to avoid looking for evidence that stocks are cheap when they had a very good run already. And this is the case. Since the end of 2011, the S&P 500 has gained 45 per cent, the EuroStoxx 36 per cent (DAX 64%) and the Nikkei 78 per cent. The relatively poor performance of the EuroStoxx reflects the distrust of investors about the future of the euro, especially the future of Italy and Spain and other countries in the periphery.

43. Since I am rather convinced that the euro will survive, with all its 18 member states, one strategy would be to **sell German stocks and buy Italian and Spanish ones.** Here is another one: as I have shown above, both short-term and long-term interest rates will remain low – in an environment of slow but steady economic growth and income distribution tilting further in the direction of capital, it makes sense to shift assets from low-yielding bond markets into "safe" stocks with high dividends.

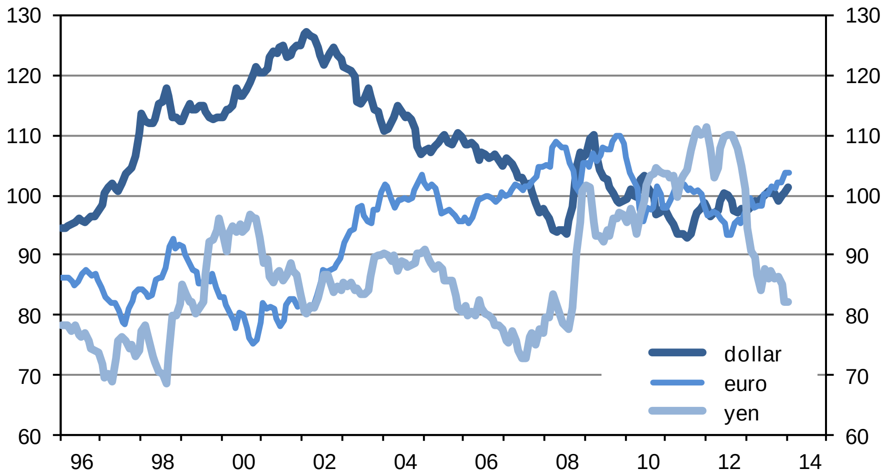
44. **Coming back to the cost of equity capital it is more likely than not that it will exceed last year's level – because stock prices are so high and will probably fall. But since money market rates and bond yields are on a slight downtrend, capital costs as a whole will only rise a little this year. They will not prevent further disinflation.**

import prices under downward pressure

45. **After the cost of labor and capital, import costs**. For the rich countries as a group, they are mainly determined by exchange rates, by commodity prices (especially oil) and the deviation of GDP growth in emerging markets from trend. These countries account for one half of global GDP on the basis of purchasing power parities.

nominal effective exchange rates

2010=100



source: Bank for International Settlements

46. **Both the dollar and the euro have been appreciating against the currencies of trading partners for almost two years by now, and the euro by more than the dollar – about 11 per cent vs. about 4 per cent.** The euro area has a giant balance on current account surplus and lower inflation rates than the US. Most importantly, the majority of market participants no longer believe that the euro will end up on history's garbage heap of failed exchange rate systems – the countries in the periphery of the currency union are on the mend and there is no lack of ammunition in case there is another crisis.

47. **The appreciation has a strong deflationary effect**. In December, Germany's import prices were down 2.3 per cent from a year ago, and I would guess that import prices in the other 17 countries have fallen at a similar rate. US import prices were -1.5 % y/y in January.

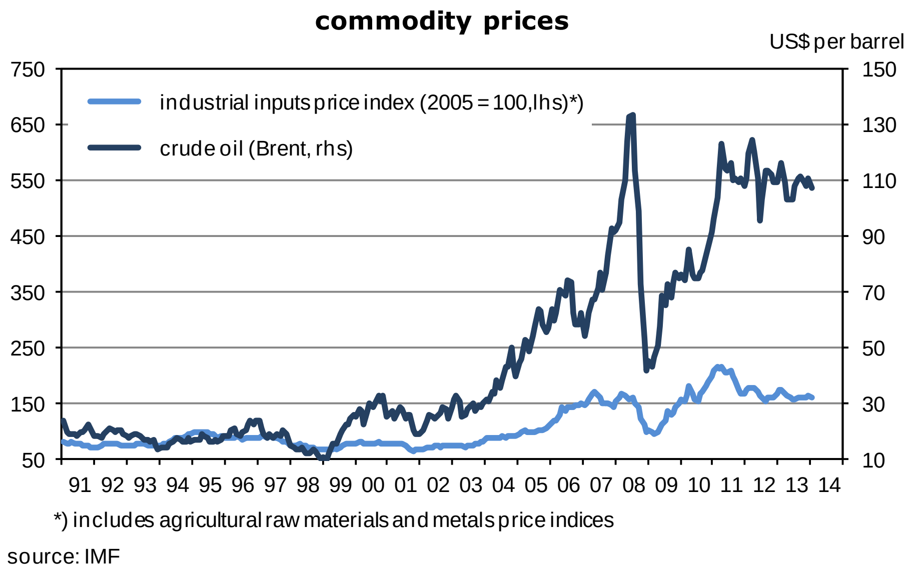
48. **The situation in Japan is totally different**: a major element of Abenomics, ie, the stimulus program, is to improve international price competiveness by pushing down the yen exchange rate. This had been successful. The trade-weighted yen has been in a free fall since 2012 and has lost 25 per cent by now. The IMF reports that Japan's December import prices were up no less than 19.1 per cent from December 2012! Japan wants inflation after all those deflation years – it is getting it via the international transmission mechanism.

49. Incidentally, a weak currency does not immediately lead to a larger balance of trade surplus. For most of the post-war period, Japan had a very big and almost structural surplus – the reason currency reserves are so large -, but it has evaporated. There is now a deficit in the order of €90bn a year. **The so-called J-curve effect is at work**: import prices (mostly of raw

materials) rose immediately in response to the depreciation of the yen while it takes much longer for exports (of manufactured goods) to increase significantly. Near-term, the increasing trade deficit acts as a sort of self-fulfilling prophesy: it triggers further depreciations.

50. **Commodity prices are still rather high**, especially oil. Markets have reacted to the commodity boom that began in earnest in 2002 in a predictable way: unusually high prices have stimulated output which in turn has put a lid on commodity inflation. Supply has caught up with demand.

51. Prices of raw materials are under pressure for another reason: **emerging economies, the most important consumers of commodities, are not growing so fast any more**. It seems that once a certain standard of living has been reached, the structure of production shifts from things that can fall on one's feet to services – and the overall growth rate declines. China's real GDP in particular is presently expanding at rates of around 7 per cent, a long shot from those 10 per cent rates of the previous decade.



52. **Oil prices are a mystery**. In spite of the shale boom in the US, cheap gas (a substitute), the fairly subdued growth of global GDP – at actual exchange rates only 2½ to 3 per cent in the three years 2012 to 2014 -, and the impressive advances of fuel efficiency, they simply do not budge. I have predicted that oil prices would come down for three years now. It is something of an embarrassment. I don't budge as well: **oil is overpriced and will become cheaper**.

53. On balance, commodity prices are on the way down. The latest readings for both dollar and euro indices were in the range of minus11 to minus16 % y/y. I expect similar declines in 2014. In other words**, commodities will continue to contribute to disinflation in the rich countries.**

54. **To sum up, disinflation is well entrenched, especially in the euro area. Holders of cash and bonds need not worry – they can sleep well.**