WEBLOG

Wermuth's
Investment Outlook

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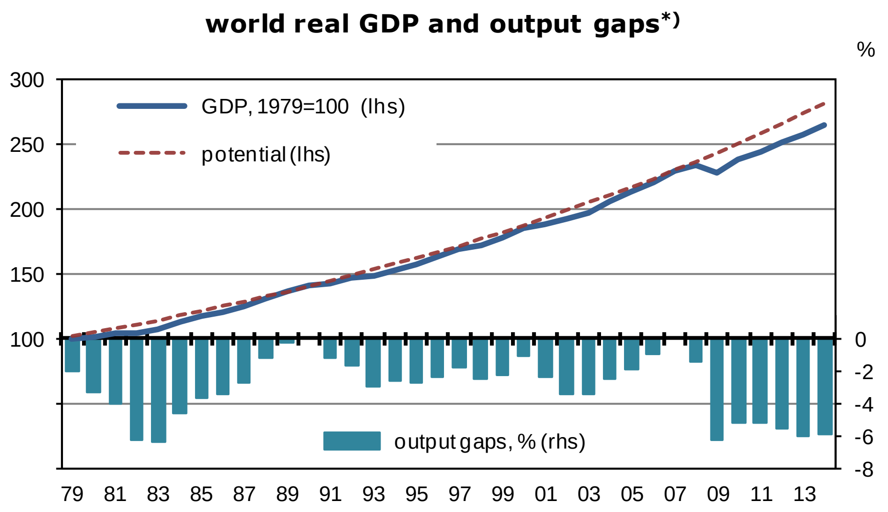
No limits to global growth so far

by Dieter Wermuth*

1. The world's real GDP will probably increase by 3.2 per cent this year if purchasing power parities (PPP) are used as exchange rates, and by about 2.7 per cent on the basis of actual exchange rates. Most forecasts, including that of the International Monetary Fund, are being revised down these days. Given these prospects, global rates of capacity utilization will stay low and the world's labor force will remain underemployed. In this regard, **growth rates could be much higher than they are today, and for a long time.** Natural resources are also still plentiful and thus not a brake on economic growth – the main limitation to medium-term growth is the ongoing destruction of the environment.

2. **Because deflation or ongoing disinflation is still a serious risk in advanced economies, policy interest rates there will not be raised in the foreseeable future. The US and the UK are closest to an exit from their ultra-loose monetary policies.**



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

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3. Financial investors will be able to achieve a real return in the order of the 3.2/2.7 per cent growth rates, if not necessarily in their home markets. Risk-averse savers who focus on high-quality government bonds with a duration of, say, five years or less, or short-term bank deposits in “safe” currencies can expect negative returns, while more adventurous investors with an international view should be able to beat the global growth “benchmarks”. **Broadly speaking, if output grows by 2.7 per cent in 2014, the owners of capital and labor should see their real income increase at such a rate as well, unless there are significant shifts in the distribution of income - which I cannot see at this point.**

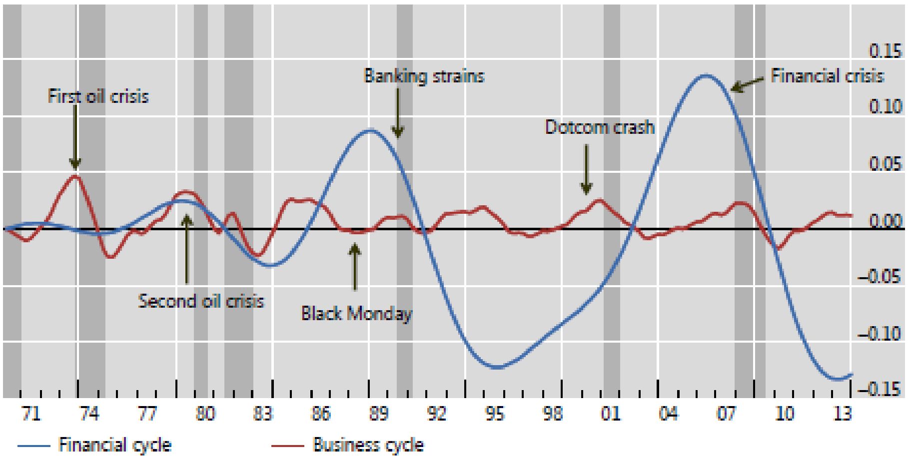
balance sheet recessions are hard to overcome

4. Growth has not yet recovered to the average 4%-rate of the two business cycles before the financial crisis (in PPP terms). In several advanced countries banks, non-financial firms and households are still preoccupied with **repairing their balance sheets – which means reducing their debt and spending less.** During the boom resources had been misallocated on a massive scale, ie, wasted. The pace of the economic expansion is still below average because it takes a long time to redirect capital and labor away from unproductive sectors such as housing. This is therefore not a normal business cycle. Conventional stimulation of demand will not do the trick. Worryingly, productive investment and productivity trends remain weak five years into the recovery from the Great Recession.

5. The tedious structural reform process in rich countries is presently the main brake on global growth. It became necessary after burst real estate, credit and equity bubbles had triggered balance sheet recessions in the private sector which then spilled over into the public sector – over the course of the financial crisis, the bail-out of financial institutions drove up the ratio of total non-financial sector debt to GDP in the G20 economies by more than a fifth (according to Jaime Caruana, General manager of the BIS, the Bank for International Settlements, in a speech on 29 June 2014). “**Aggregate debt levels continue to grow**. Overall, debt-to-GDP ratios are now 275% in the advanced economies and 175% in the emerging market economies. ... (Meanwhile), a number of emerging market economies have moved into the later stages of their own financial booms.”

6. Claudio Borio, the economic mastermind of the BIS, has recently presented a graph which suggested that **financial cycles – which capture cycles in real credit, credit-to-GDP ratios and real house prices – are much longer than normal business cycles, have become bigger since the early 1980s and their busts coincide with balance sheet recessions.** These busts cause permanent output losses and significantly reduce the room for policy manoeuver and the responsiveness to aggregate demand policies. In the US, the return to “normal” will not occur before 2020 if the results of his research can be trusted. For Europeans, this is unpleasant news because they are much less advanced in the deleveraging process than the Americans.

financial and business cycles in the United States



source: BIS 84th Annual Report, p. 68

7. The implication is that economic growth will remain below par for very long. Looking at the valuations of equities in OECD markets, financial investors are much more optimistic. Their optimism about future profits needs yet to be validated by stronger economic growth. It is hard to see how. Most equities are therefore expensive. They may have to be bought anyways because they are probably the best of the bad alternatives.

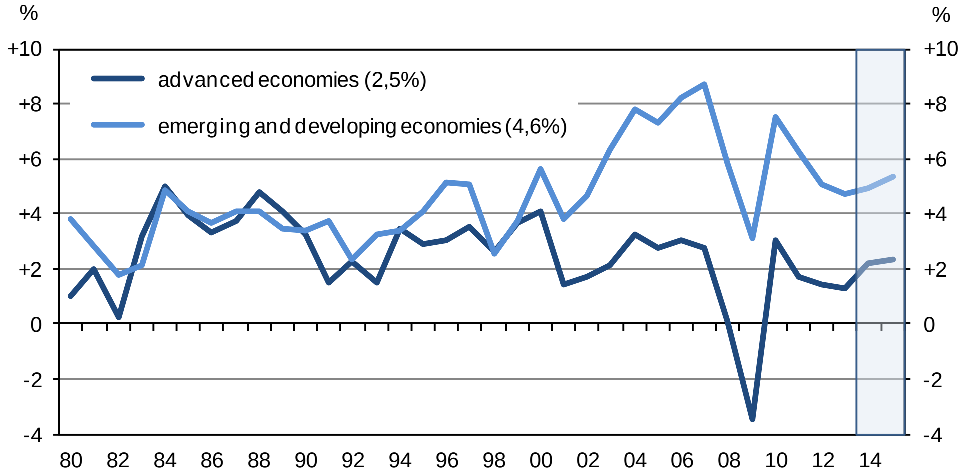
8. **Another drag on demand is the poor state of government finances**; these had been damaged by the recession and the cost of bailing out banks. Since debt levels are still mostly very high, fiscal policies are restricting rather than stimulating overall demand. In 2014, gross government debt to GDP ratios are expected to be 120 per cent in the US, 240 per cent in Japan and 95 per cent in the euro area (with Germany at 75, France at 95, Italy at 135, Spain at 96). Time was when a ratio of 60 was considered to be an acceptable upper limit.

9. There is certainly no scarcity of labor and production capacities. The world economy is far from full employment and could expand at a much brisker pace if the conditions were right. But they are not right yet, especially in the rich countries.

emerging Asia is the world economy’s center of gravity

10. It is Emerging Asia, with a real GDP growth rate of 6 ¼ per cent this year, which continues to be the strong engine that drives the global economy. **According to the World Bank, China is about to overtake the US in terms of purchasing power parities and will thus become the world’s largest economy.** Per capita, GDP will still be just a quarter of America’s. So this is obviously not the end of the road for China – and the rest of the developing world. 85 per cent of the people on this planet live there. Shares of firms which successfully do a major part of their business in this high-growth region are the investment vehicles of choice for savers in North America, western Europe and the OECD countries of Asia.

real GDP growth rates of advanced and emerging economies*)



*) PPP; 2014, 2015: IMF projections;
in parentheses: average annual rates of growth (1980 - 2013)

source: IMF

11. **Among the large emerging economies, the main negative outlier in terms of growth is Russia.** Some of the country's fundamentals are very sound: the government budget deficit is only one half of one per cent of GDP, and the current account surplus is heading toward 1 ½ per cent of GDP. This reflects the high level of oil prices which have boosted export revenues as well as commodity-related taxes. There is so much money around that real wages have been allowed to rise by no less than 4 per cent year-on-year, in an environment of persistent economic stagnation. Together with a depreciating rouble, this has pushed up consumer price inflation to 7.8 per cent in June.

12. **Russia's main problem, especially in comparison to China, is the low level of capital spending.** This is caused by several factors: Russians as well as foreign investors are scared by the government's belligerent antics in neighboring Ukraine; the centralization of economic power discourages entrepreneurship and competition; and there are no signs that corruption will be fought in earnest. Too much still depends on high oil prices. A diversification of the economy away from commodities is still a long way off. On some measures, Russian equities are cheap: the current year price-to-earnings ratio is just 5.5; the price-to-book ratio is well below 1 (0.74). On the other hand, the dividend yield is only 3.6 per cent and thus negative in real terms – low payout ratios make Russian stocks unattractive for institutional investors.

growth has returned to the euro area

13. On the basis of purchasing power parities, **advanced economies will probably expand by 1.6 per cent year-on-year in 2014**, compared to last year's 1.2 per cent. The largest positive contribution to the acceleration of growth comes from the euro area where the two-year recession has ended. OECD trend growth before 2008 had been 2.8 per cent. It now looks that such a rate cannot be achieved again for years to come.

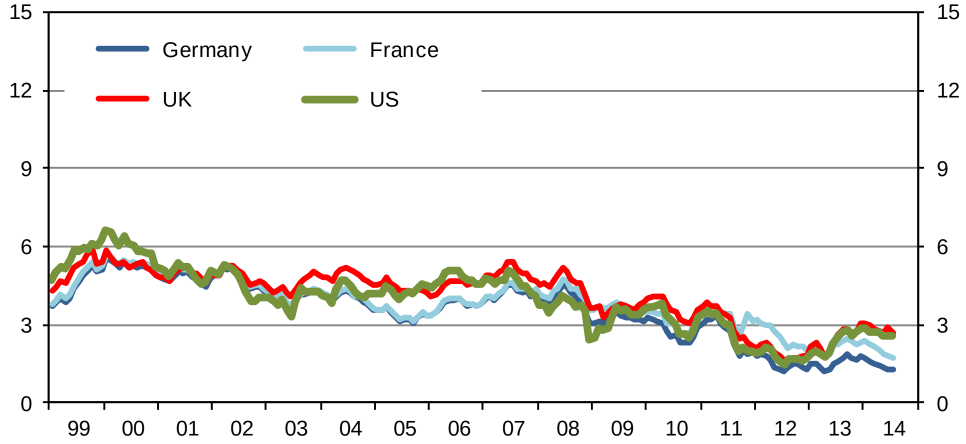
14. **The real GDP of the euro area will probably expand by 1.1 per cent in 2014, not enough to bring down the unemployment from its present 11.7 per cent**. Job risks are considerable, especially for the young. In spite of extremely expansionary monetary policies such as near-zero policy rates and the coming unlimited and record-cheap supply of central bank money that will be available through September 2018, the effects of deleveraging in former crisis countries, structural changes caused by the re-allocation of resources and mostly tight fiscal policies will prevent a significant acceleration of growth.

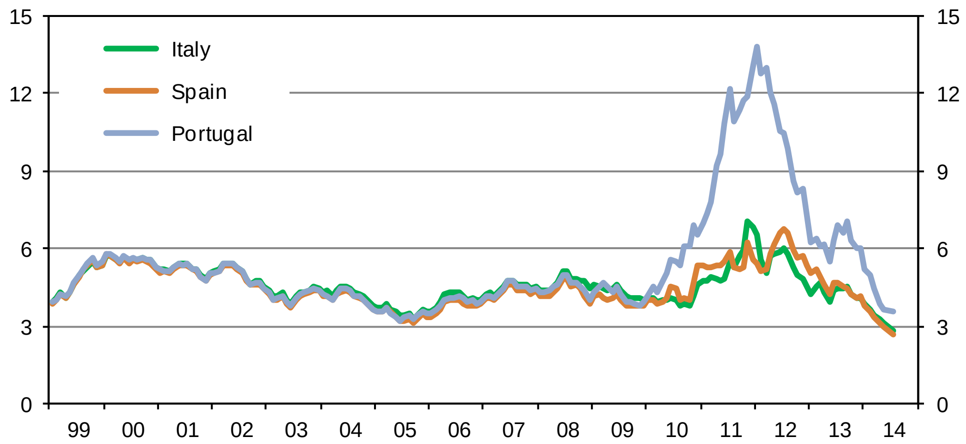
15. Incidentally, in the twelve years before 2008, average real GDP growth in the euro area had been no less 2.3 per cent. Since the average growth rate in the seven years that followed has been -0.5 per cent, there is **no doubt that the European output gap is huge** - even if one concedes that the new trend rate of potential GDP is not 2.3 per cent anymore. It could be down to something like 1.5 per cent.

16. **Investors do not have sleepless nights over the future of the euro anymore.** They have been piling into the bond and stock markets of the former (?) crisis countries in the periphery after ECB president Mario Draghi had credibly assured markets two years ago that the euro would not be allowed to fail. Those who took him by his word have earned a lot of

government bond yields

- 10-years, percent, monthly averages -





sources: European Central Bank, Bank of England money. The question today is whether the narrowing of yield spreads has gone too far. Should profits be taken? 10-year government bond yields in Greece have fallen to 5.8%, in Portugal to 3.6%, in Ireland to 2.3%, in Spain to 2.7% and in Italy to 2.8%. The situation is not much different than before the financial crisis that began in the summer of 2007: investors have been betting on a further integration of the euro area bond markets.

17. **In real terms, yields in the peripheral bond markets are still fairly attractive.** Average euro area headline inflation is just 0.5 per cent. It helps that policy makers have made great strides toward a full-fledged banking union, with a rigorous bank asset quality review under way, a central bank supervisor at the ECB (from next November) and first agreements about a common resolution and recapitalization mechanism for banks. Progress in this regard has been faster than I had thought possible. The euro enjoys so much popular support in all member countries that the resistance against the transfer of power over banks to the ECB in Frankfurt is rather weak.

US: near-term outlook is positive

18. In the US, medium-term growth also leaves much to be desired. After the annualized 2.9 per cent decline of real GDP in Q1, the year-on-year average rate of growth for the whole year will be a little more than 1 ½ per cent. **The investment bank Barclays has just revised down the country's potential GDP, ie, medium term trend growth, to 2 per cent.** One reason is that the dollar is overvalued which constitutes a drag on foreign trade and aggregate demand; the merchandise trade deficit is getting bigger again (3% of GDP). Another reason is the reluctance of consumers to spend: hourly wages have been rising at roughly the same rate as consumer prices, the labor participation rate remains depressed, and many households are still busy repairing their personal balance sheets which had been devastated in 2008/2009. Moreover, non-residential private investment expands at an unusually slow annualized rate of about 4 per cent, after 3 per cent in 2013, in spite of easy monetary policies and record-high corporate profits. Sales expectations are not optimistic enough for a genuine investment boom. As the capital stock expands only slowly, it is not possible to lift the economy onto a higher medium-term growth path.

19. **Yet, the near-term outlook for the American economy is quite good.** After the weak start into the year 2014, caused mostly by unusually bad weather, a strong rebound seems to be under way, especially on the labor market. While the old employment high of 2008 has just been reached this spring again, the number of jobs had expanded at an average annual rate of 1.6 per cent since the last cyclical low in early 2010, a higher rate than in Germany (where, in contrast to the US, employment had been almost unaffected by the 2008/2009 recession, though).

20. This looks like a stable trend which will support household consumption, the largest component of demand by far - which in turn has already led to an **acceleration of the core personal consumption expenditure (PCE) price index.** In the three months through May, it has increased at an annualized rate of 2.1 per cent, compared to 1.0 per cent in the three preceding months. This is more or less where the Fed wants it to be. No wonder that

analysts have begun to bring forward the date at which the Fed will exit its ultra-loose policies (from 2016 to the second half of 2015).

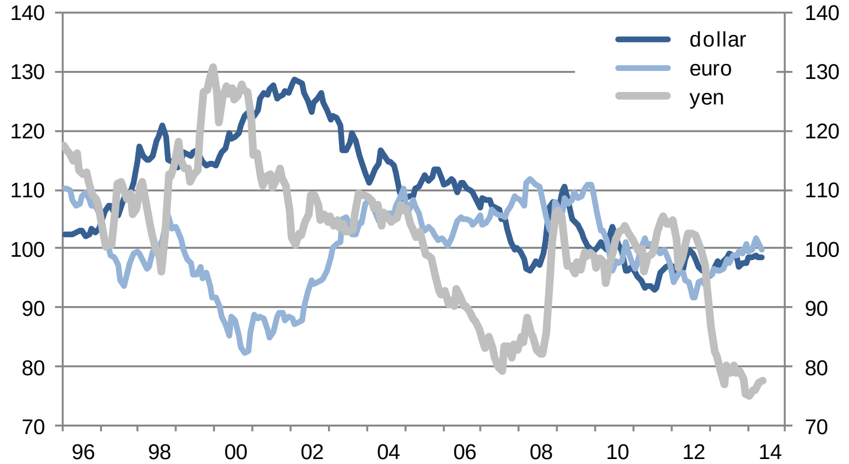
21. Interest rates on two-year and five-year Treasury issues have already increased a lot, to 0.51% and 1.73%. In the euro area (Germany) comparable rates are still only 0.01% and 0.34%. The differences suggest that traders and investors still believe Mario Draghi's forward guidance - that policy rates will stay at their present level for "an extended period" -, but **do not trust that Janet Yellen can uphold her and her predecessor's promises to keep policy rates near zero for a long time.** In other words, long-term dollar bonds are fairly dangerous assets these days. But not only dollar bonds: keep in mind that the world's main bond markets are closely linked – if the sell-out in the US starts one day, markets in Europe and Japan will move in the same direction, if not by as much.

22. **American stocks are fairly expensive**, considering that economic growth is lackluster and that bond prices have begun to weaken. The S&P 500 p/e ratio on the basis of expected 2014 earnings is 16.7 which translates into a risk premium of 5.4 percentage points. Not bad, but not exactly a steal. The price-to-book ratio is a hefty 2.75, and the dividend yield is only 1.45 per cent, less than inflation expectations.

23. **As to the dollar, the rising difference in short-term interest rates tends to strengthen it against both the euro and the yen.** Longer-term, the main driver is changes in the balances on current account which represent the fundamental, non-speculative demand for a currency. After the current strength of the greenback, I expect a new round of devaluations, starting at the time when the Fed announces its exit from present policies and thus triggers a global increase in interest rates. The current account surplus of the euro area is 2.5 per cent of GDP; Japan's is just 0.2 per cent but will probably rise from now on in response to the large depreciation of the yen. So these two currencies are about to face a rather unwelcome appreciation sometime next year – unwelcome, because this has a restrictive effect on demand.

real exchange rates

2010=100



source: Bank for International Settlements

inflation has returned to Japan, but probably not permanently

24. The Japanese economy continues to overcome its two decades-old balance sheet recession, helped by the large effective depreciation of the yen since the fall of 2012 which followed the **Abe government's announcement that it would not stop expansionary policies, including massive quantitative easing, before there was evidence that deflation had been defeated for good.** The recent VAT hike has pushed the year-on-year consumer price inflation rate temporarily to more than 3 per cent; inflation expectations three or five years ahead are still stuck at around 1 ½ per cent. 10-year government bond yields of 0.56% actually suggest that inflation is expected to be even lower further out on the time line.

25. GDP growth remains moderate in the neighborhood of 1 ½ per cent as well. Massive fiscal deficits (presently 8 to 9 per cent of GDP) and zero interest rates have persisted for a long time but have failed to kick-start the economy. The danger is that households and firms have become hooked to these policies - which makes it very dangerous to exit them.

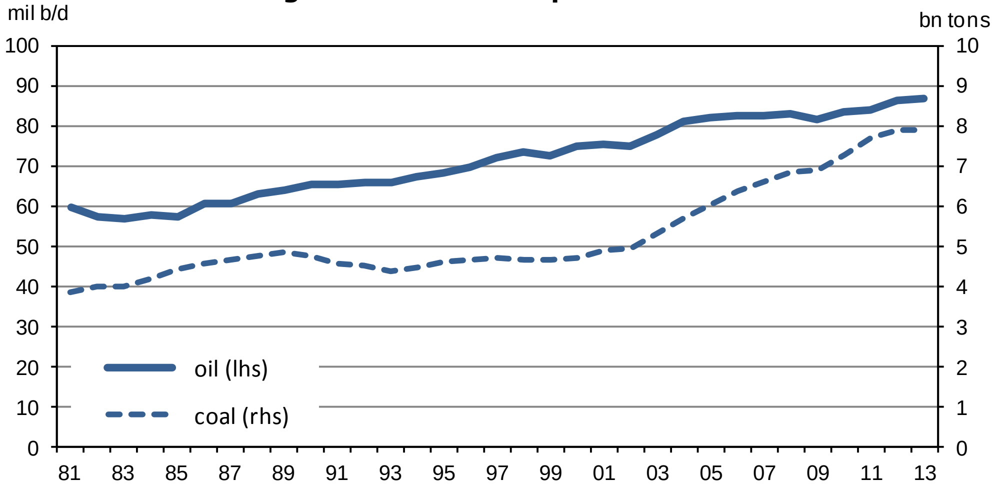
26. Even so, in the **near-term things are proceeding smoothly. Japan is a slow-growth country, but the standard of living remains high, and the unemployment rate is just 3 ½ per cent**. Since international competitiveness has improved considerably, it is likely that the next big move of the yen will be an appreciation. Investors can also bet on the robust expansion of private and public investments.

27. Stocks are not cheap, though, with a 2014 p/e ratio of 17.4 and a price-to-book ratio of 1.57. On the other hand, the risk premium is one of the world's highest (about 7 percentage points over real long-term bond yields). **Government bonds are extremely expensive**, no matter which yardstick is used – there is no compensation for the risk that yields have only one way to go: up.

no shortage of natural resources – but the environment continues to deteriorate

28. Some people are convinced that we are running out of natural resources and that the era of cheap raw material inputs has ended – which in turn is supposed to hold back GDP growth. It is not rocket science to forecast that the world will one day run out of resources. Resources are obviously limited by the size and composition of the earth. But **as their prices increase in response to scarcity, their consumption increases less or even declines while production goes up. For an economist or businessman, available resources are therefore unlimited.** They will not act as a brake on economic growth. It is also not a foregone conclusion that the prices of commodities will, over time, increase relative to general price levels. As the following graph shows, even the output of crude oil continues to increase year after year, well beyond the date at which it was supposed to peak.

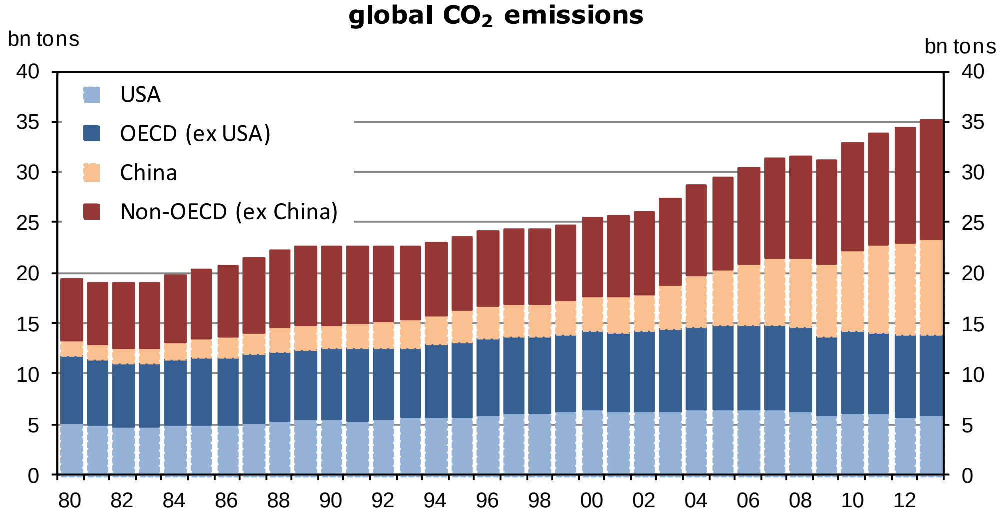
global oil and coal production



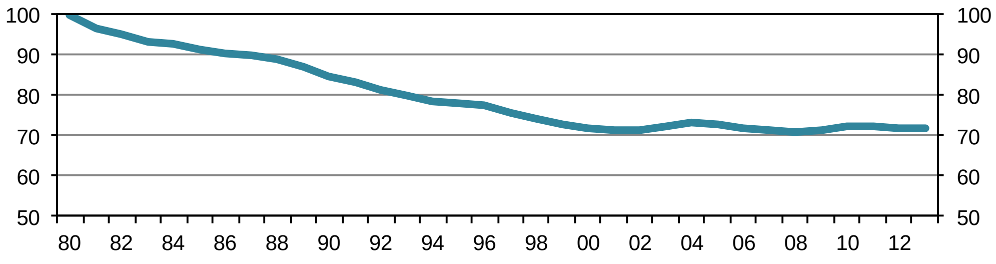
source: BP Statistical Review of World Energy June 2014

29. The **catch-up process of emerging countries that is the driver of the world economy is not about to end because of a shortage of energy and other inputs. There is no such thing. Growth is strong because productivity gains are large**; they come from technological leapfrogging and economies of scale. Combined with high savings and investment ratios as well as rapidly expanding labor forces I expect the growth rate of real GDP in this part of the world – which now accounts for one half of global output in PPP-terms - to remain two to three times higher than in advanced countries. In 2014, it will be 4 ½ to 5 per cent.

global CO_2 emissions



ratio of CO_2 emissions to global real GDP, 1980 = 100



sources: BP Statistical Review of World Energy June 2014, IMF, own calculations

30. But the ongoing destruction of the environment in this part of the world will increasingly act as a brake on economic growth. As standards of living in terms of money spent on goods and services rise in lock-step with the world's GDP, the strains this causes in the natural habitat become more apparent. The desire of once poor people to buy cars, larger apartments and houses, air conditioners, TV sets, washing machines, imported food and to travel by plane is still stronger than their concern about the ecological effects this causes. **The emissions of carbon dioxide and other greenhouse gases continue to rise relentlessly, if somewhat slower than the world's real GDP.**

31. This means that health hazards and other negative externalities are getting more serious while the globe's average temperature keeps rising, with unknown but probably quite dangerous consequences. **Environmental concerns will move up on people's list of priorities as they get richer. The Green movement had its origin in the wealthy and densely populated countries of the European Union.** It became less and less acceptable to dump one's waste in someone else's front yard. Increasingly, polluters have to pay for the damage they cause.

32. In other words, **the traditional production model must be modified**. Producing without regard to the environment and then throwing things away after the end of their useful life is less expensive than designing them for resource efficiency and recycling. Consumers must also be given strong incentives to participate in the process. Fifteen years ago, Swedish voters have forced their politicians to avoid putting waste into landfills. Today, landfilling accounts for only 1 per cent of municipal waste disposal; the rest is, in equal parts, recycled and incinerated. Sweden is a trend setter in many ways.

33. **Well-run firms that fight waste and the destruction of the environment have obviously a promising business model** – which they will be able to export to those emerging economies where society has achieved a certain standard of living and no longer accepts the unlimited pollution of air, water and land.

conclusions

34. Since output gaps are not really closing, it is unlikely that inflation rates will move up significantly. Most analysts expect exactly that, though. They cannot imagine a growing world economy and falling inflation rates at the same time. But Japan has shown that it can happen. Since the euro area is in a similar situation, **I would not be surprised if bond yields there fell further, especially in its peripheral markets.**

35. **The US and the UK are closer to an exit from easy monetary policies** than the euro area and Japan: their bond markets are therefore at risk. The recommendation is to shorten duration.

36. **In advanced economies, most stock markets have had a good run and are no longer cheap. But high-dividend stocks are still a sensible alternative to "safe haven" bonds.**

37. **Emerging economies** are the world's growth engine and thus a plausible place to invest. Their stock markets are still licking their wounds after the 2008 crash that had taken care of the hype of the previous years. While most of them are quite cheap now, corporate governance issues make investments quite risky. **Exchange traded funds (ETFs) are an alternative, or stocks of rich-country firms that are successful in the emerging world.**

38. An increasingly important investment theme are **"green" firms** – the global environment continues to deteriorate. As once-poor countries get richer, the constituency for preserving the natural habitat gets bigger quite quickly.

39. **Euro and yen are fundamentally strong currencies**; near-term they may come under pressure as interest rates continue to rise in the UK and the US.

40. Most **commodity prices** will remain under downward pressure: they are still high in a historic perspective, global GDP growth is only moderate, and production has caught up with demand.

41. **Crude prices** are elevated, but not for fundamental reasons. Once peace returns to the Near East they will fall considerably.

42. **Gold** should be sold – there is no need for inflation hedges.