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Wermuth's

Investment Outlook

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January 19, 2015

Deflation is here

by Dieter Wermuth*

1. If we accept central banks' definition of price stability as an annual increase of the consumer price index by 2 percent, or somewhat less, we can call anything beyond, say, 2.5 percent as inflation - and 1.5 percent or less as deflation. It is well known that the true underlying price index which takes into account quality improvements and shifts in consumption patterns is actually declining once the headline inflation rate falls below 1.5 percent or so. Using such an approach, **US deflation began in March 2013, euro area deflation in April 2013, almost two years ago already, and Japanese deflation in October 1992 (!)**. Leading indicators such as rates of capacity utilization, unit labor costs and commodity prices suggest that we are not yet near the lower turning point. **Deflation is here to stay, for a while at least.**

2. **Financial investors should reallocate their assets to benefit from falling prices of goods and services. Inflation hedges do not make much sense right now** - and for the foreseeable future - which means the share of real assets such as gold, most other commodities, growth stocks, real estate and currencies of commodity exporting countries should be reduced (or shorted) while nominal assets such as fixed income securities or cash should be overweighed, as should be currencies of commodity importing and net creditor countries.

3. The recommendation to shift the emphasis from real to nominal assets is, of course, very broad brush and in specific cases possibly the wrong strategy. **The arrival of deflation is just one aspect that has to be taken into account**. Just as important is whether asset prices are seriously overpriced or underpriced, based on their deviation from trend or compared to the income they generate. The general statement that real assets should be shunned in deflationary times **must be modified by the results of a close look at their actual valuations**. I can, for instance, imagine that the oil price will fall below 30 dollars in the near term, or the yield of 10-year Bunds to 0.2%, but at such levels it would be risky to sell oil, a real asset, or to buy Bunds, a nominal asset. Also, **assets that usually qualify as inflation hedges can be attractive in deflationary times if they reliably produce high dividends and other income;** think of dividend stocks like re-insurers or real estate investments that are not overvalued relative to average household incomes or the rents they earn.

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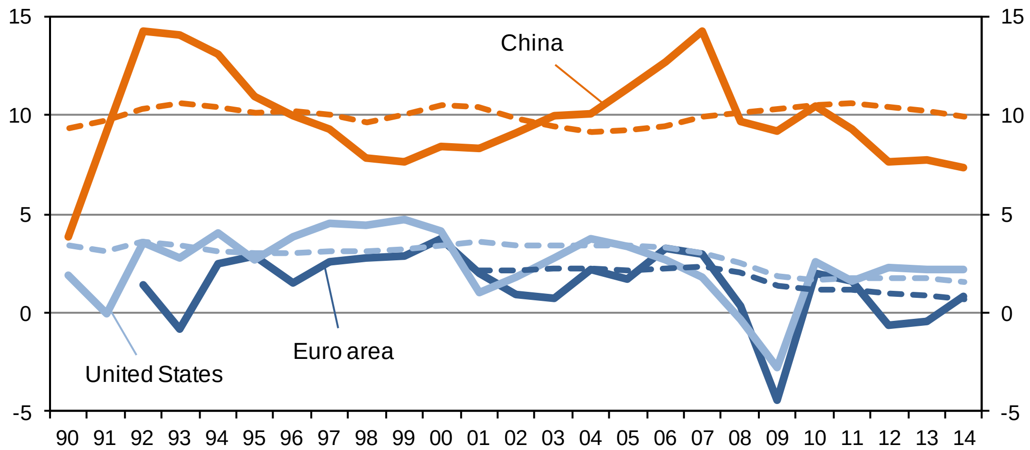
deflation has gone global

4. Surprisingly, **deflation is not just a phenomenon in rich countries any longer**. Investment bank Barclays presently predicts the following inflation rates for 2015: China 2.0, South Korea 1.3, Singapore 1.2, Taiwan 1.5, Thailand 1.3 and Poland 0.3 percent. These countries are all important and successful players in international markets. For most other Asian, Latin American, East European and African economies, inflation is considerably higher, but I notice that forecasts have mostly been revised down in recent months. Outliers on the upside are Venezuela (100%), Argentina (42%) and Russia (11%).

5. Emerging economies are characterized by relatively high inflation rates: **as a rule of thumb, when OECD inflation is 1 percent, emerging market inflation is somewhere around 5 percent.** Nothing to worry about! Since growth rates of output per capita, ie, productivity, in the sectors that are exposed to international competition, are rising quickly – which is a normal feature during processes of catching-up with advanced economies -, wages in this part of the economy are also rising pretty fast, in turn pushing up wages elsewhere as well as general inflation. As unit labor costs usually remain under control, **high inflation does not mean companies will lose business to foreign competitors. I am more worried about the fact that emerging Asia inflation rates have lately fallen to 2.3 percent.**

6. In other words, deflation (or disinflation) is a global trend by now. For whatever reason, global demand for goods and services is not expanding fast enough to reduce spare capacities and boost labor participation rates. It is therefore **likely that monetary policies in the world's main economies will remain expansionary.**

real GDP growth*)
% y/y



*) dotted lines indicate 10-y moving averages (2014 : China 10.0%, US 1.6%. Euro area 0.7%)

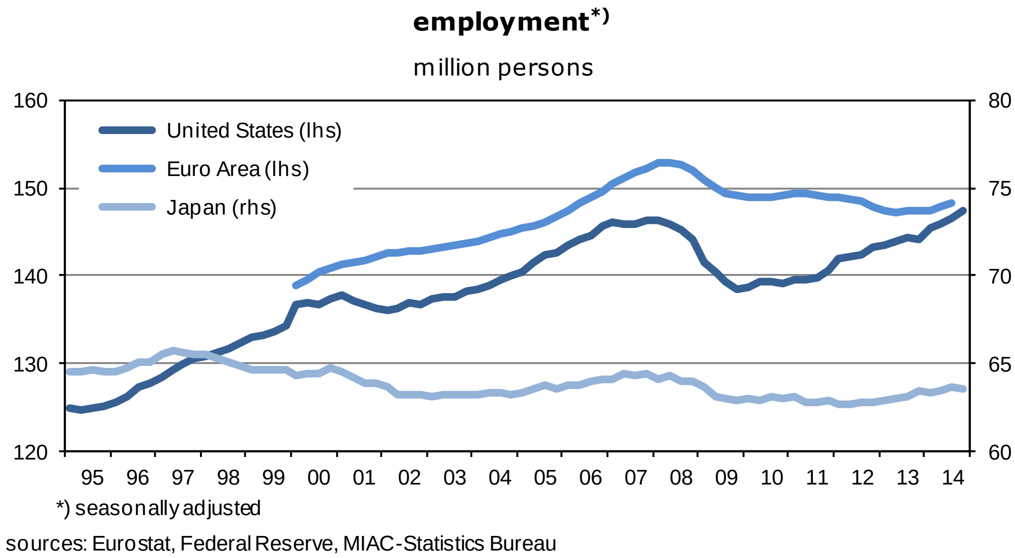
source: IMF

US consumer prices are falling

7. This includes the US – the appreciation of the dollar exchange rate over the past year is comparable to a significant increase of the Fed funds rate. The strong dollar will not only

reduce America's net exports, ie, overall demand. Together with the steep oil price decline it may push the **average year-on-year headline inflation rate to -0.1 percent in 2015**; this is the latest forecast from Barclays. US import prices are already 5.5 percent lower than one year ago!

8. Moreover, in spite of the pleasant news on employment the **US labor market** is not really in good shape yet. **The key indicator here is the labor force participation rate which continues to fall, a sign that there is a lack of attractive jobs.** The rate has steadily come down from 66.4 percent in 2007, before the financial crisis, to 62.7 percent last month. There are still plenty of discouraged workers, people who have given up looking for a job. Add to this that in the past six months, average hourly earnings of all employees have increased by a more than meager annualized rate of 0.8 percent (which has actually been a slight increase in real terms because consumer prices had come down at an annualized rate of 0.4 percent). In such an environment, the Fed does not need to move.



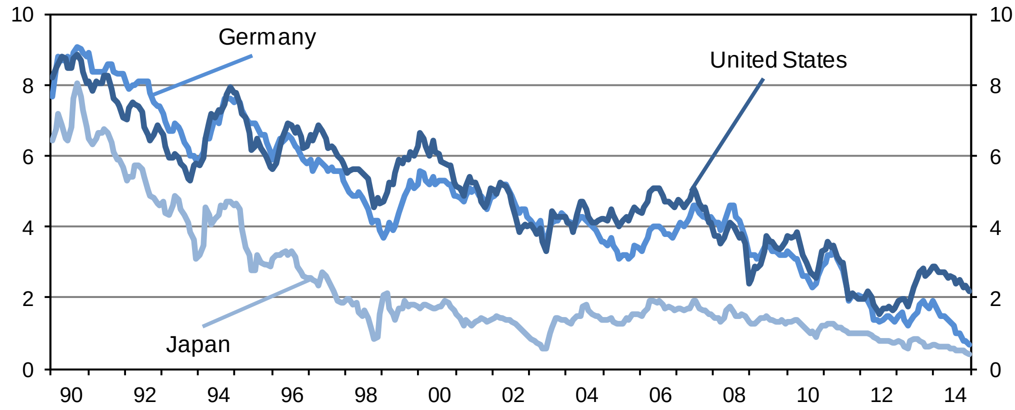
9. **To bet on a further dollar appreciation, based on consensus forecasts of 3 percent real GDP growth and a rising Federal funds rate in the second half of 2015, looks therefore quite risky to me.** The fact that the US is still running a sizeable current account deficit – compared to a large surplus of the euro area – is a fundamental factor which limits the upside potential of the dollar. Moreover, the dollar has appreciated a lot already, and the economic situation of the euro area which is usually assumed to remain depressed may turn out better than expected – the weak euro and the even weaker oil price help.

10. **What I would bet on is a further reduction of long-term dollar interest rates**. At 1.84%, the yield for 10-year Treasuries remains attractive, even after the steep decline from its last high of 2.62% last fall. According to the so-called inflation linkers, expected average inflation for the next ten years is 1.6% in the US; in real terms, the yield is therefore positive - in Germany, inflation expectations are 0.6% while the 10-year Bund yield is 0.46% today, ie, it

is negative in real terms. Longer-term Treasuries are cheap in both absolute and relative terms.

government bond yields

- 10-years, percent, monthly averages -



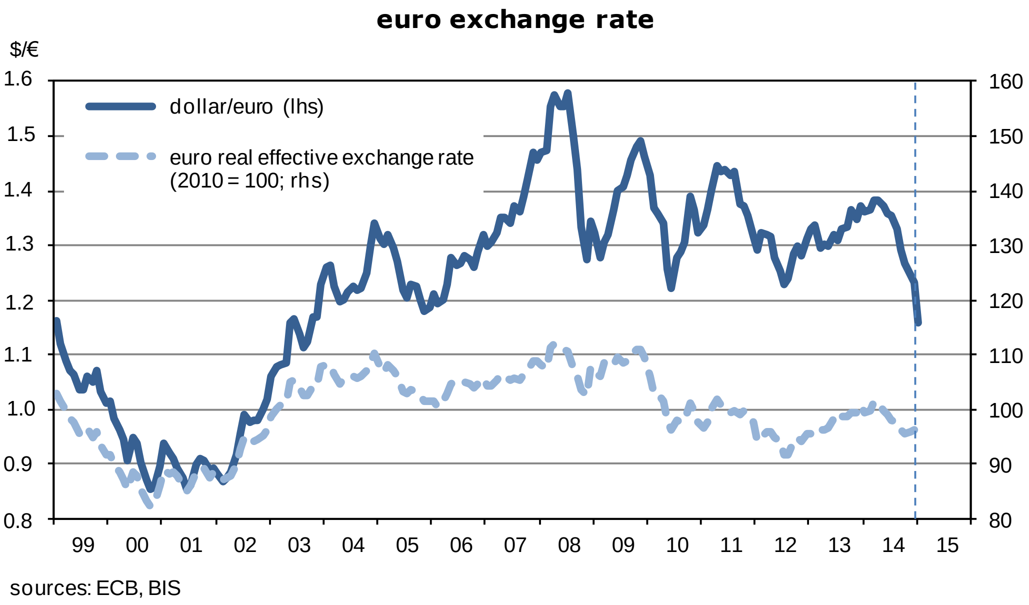
sources: Deutsche Bundesbank, Federal Reserve, ECB

why the euro will not depreciate much more

11. Turning to the euro area, the currency union has just escaped the second leg of a double-dip recession; the first one took place in 2008/2009, the second one in 2012/2013. After a growth rate of 0.8 percent last year, the present **mainstream forecast for 2015 calls for real GDP to increase by a little more than 1 percent. As I see it, chances are that the outcome will be quite a bit better. Here are the four main reasons:**

- **The collapse of the oil price and energy prices in general has boosted the purchasing power of households and the economy as a whole**: as the cost of importing energy has collapsed, Russia, OPEC and the other producers and exporters of mineral fuels have effectively provided the euro area with a massive stimulus program; I estimate that in 2015 such imports will cost about €180bn less than in 2013 (when they were €437bn), the equivalent of almost 2 percent of nominal GDP. The euro countries combined would never have contemplated raising government expenditures or cutting taxes by such an amount.
- In spite of sound fundamentals the exchange rate of the euro has been under downward pressure since last spring. With inflation heading into negative territory, the depreciation has been welcome – it has slowed the disinflation process. At the same time, the **price competitiveness of European firms has been improved a lot which means that net exports will probably provide a larger boost to overall demand and therefore growth than initially expected;** their contribution to overall GDP growth could easily reach 0.5 percentage points rather than the 0.2 percentage points incorporated in most forecasts today.

- By now, it has become **unlikely that fiscal policies will be tightened further**. Germany has been running a government budget surplus of almost 1 percent of GDP. Given that the output gap remains huge, this translates into a very large cyclically adjusted budget surplus - tighter fiscal policies can therefore be ruled out. For the euro area as a whole, expansionary fiscal policies would be the right recipe, given the huge amount of slack in the economy. This will not happen, but the likely end of belt tightening that I now expect will be enough to give a boost to the economy.
- **I also believe that the so-called geopolitical tensions will ease off** – for many analysts they had been responsible for the disappointing growth of investments (0.6% y/y) and therefore GDP last year. Russia cannot afford to continue its land-grabbing policies in Ukraine: the West's sanctions against the financial sector have obviously been very effective, while the oil price crash is devastating government finances and household incomes. The deep recession that is now unfolding is a serious risk for the Putin administration. To let the conflict escalate further is almost suicidal for the authoritarian one-party state, and therefore unlikely.

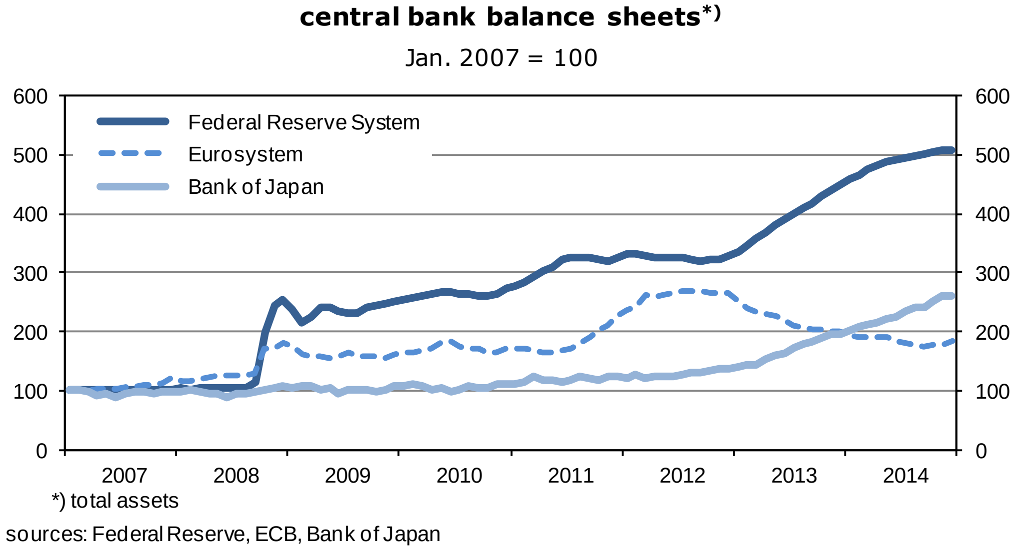


12. Adding up the numbers suggests that the **euro area may expand at a rate of perhaps 2 ½ percent in 2015** and thus exceed most forecasts. There is no lack of spare capacities, and the unemployment rate is still above 11 percent. Deflation will become more entrenched, though.

ECB keeps the foot on the accelerator

13. It is now almost certain that the ECB, after interest rates cannot be lowered any more, will revert to quantitative easing, the expansion of its balance sheet by means of large-scale secondary market purchases of government and other high-quality bonds. Against the central bank's intentions, its balance sheet has shrunk for more than a year as banks, faced with weak credit demand and still intent on improving the quality of their balance sheets,

have been running down their borrowing from the Eurosystem (ie, the ECB). **Flooding the banking sector with central bank money is once again supposed to encourage lending, boost the demand for goods and services and close the deflationary output gap.**



14. In the end, the ECB wants to achieve its self-proclaimed goal of lifting the inflation rate as well as medium-term inflation expectations to just below 2 percent. With headline inflation in December at -0.2 percent year-on-year, it will be a long haul. **Monetary policy is currently pushing on a string and does not have a clue how things can be made moving again.**

15. **The weak euro has been an unexpected ally in the ECB's fight for higher inflation** but, as the recent depreciation of the yen has shown in Japan, the inflationary impact is rather limited in a world of falling price levels. On balance, though, the ECB does what needs to be done and provides plenty of liquidity at extremely favorable conditions.

16. **Monetary policies are so ineffective because they are not supported by fiscal policies.** The ECB does not dare to point out that euro area governments, the German one in particular, should stop austerity and get out of the pro-cyclical Maastricht straightjacket. If the private sector does not generate the demand to fill the large output gaps, the public sector has to come to the rescue. Inflationary risks are non-existent and would actually be appreciated. Fighting deflation and getting Europe back to work are the real issues of the day.

17. **Public debt is not a bad thing in itself in an economy that has more foreign assets than liabilities and does not borrow in foreign currencies**. When will governments ever be able to borrow 10-year funds at rates of 0.45% (Germany), 0.63% (France), 1.49% (Spain) or 1.65% (Italy) again, to name just the largest of the lot? Here is an opportunity that must not be missed. It should not be difficult for the public sector to identify projects in infrastructure and education whose returns on capital exceed these interest rates by large margins. According to the "golden rule of government borrowing", raising debt in the market place is ok as long as it is used to boost the capital stock of the economy, including human capital. Wished the euro area finance ministers were as relaxed about public debt as the US

Treasurer, the American public - and the rest of the world which eagerly picks up all that dollar debt.

public debt and growth

	general government debt		change in real GDP
	2007	**2014**	**2007 - 14**
	% of GDP		*%*
Euro area	65.0	94.7	-1.0
Germany	63.5	74.5	4.6
France	64.2	95.5	2.2
Italy	99.7	132.2	-8.6
Spain	35.5	98.1	-5.1
Netherlands	42.7	69.7	0.0
Greece	103.1	175.5	-25.5
Portugal	68.4	127.7	-6.4
Ireland	24.0	110.5	-2.4
memo			
United Kingdom	43.6	89.0	4.3
United States	64.0	105.1	7.9
Japan	183.0	246.1	1.5

source: AMECO; own calculations

18. **Financial investors wonder whether euro area yield spreads can narrow further**. Before the financial crisis they had almost disappeared, followed by a dramatic widening as the economies of the so-called periphery teetered on the brink of bankruptcy. Bailing-out their banks often exceeded governments' financial means and forced them to ask for help from the IMF and the other euro area countries. To get that help they had to implement structural reforms, mostly of labor markets – which pushed up unemployment to unprecedented levels - , and agree to "internal" devaluations, substitutes for outright devaluations which are not possible in a currency union. De facto this meant a reduction of wages and the large-scale lay-off of less productive workers.

19. At the same time, the **safety net of the euro was strengthened** a lot, including a support mechanism such as the ESM and a common bank surveillance at the ECB, while Mr. Draghi made the powerful statement that the ECB would do whatever it takes to stabilize the euro. He reminded markets that there was no limit to its financial means.

20. **It is now a much safer bet than before 2007 that the euro will survive. Yield spreads could therefore decline some more.** To me, it is reassuring that they have shrunk at a time when the euro itself is under a lot of outside pressure.

Greece will not exit the euro

21. **How about "Grexit"?** To some extent, the depreciation of the euro has been caused by the suspicion of market participants that Greece may be forced to declare default, leave the euro and prompt others to do the same, heralding the end of the euro. Especially in the countries of the periphery, but including a heavyweight such as France, **the public is fed up with those internal devaluations.** Anti-euro parties are therefore on the rise and challenge the pro-European establishment.

22. In response to the new escalation of the Greek financial crisis not only the German government has drawn up contingency plans – how can the risk of a Grexit be contained in an orderly fashion? The message from Berlin was "let the Greeks go, we will manage". But I think this is just bluffing. **Greece will stay, effective interest rates on its debt will remain close to zero (lower than Germany's) and repayment schedules will be stretched further.** Debt forgiveness cannot be sold to taxpayers in the creditor countries, so indirect approaches that have the same effect will be preferred.

23. The good thing about the present crisis is that some key components of the currency union will have to be given up, if not officially (such as the 3% and 60% deficit and debt criteria). Austerity is exactly the opposite of what is needed in a situation of underutilized resources. **If Greece is let off the hook, others will sensibly demand to be treated more leniently as well.** All this will contribute to somewhat more expansionary, or less restrictive, fiscal policies, faster economic growth, a reduction of deflationary pressures and perhaps even to lower debt ratios – as the most effective way to reduce the government debt burden is to boost the growth of nominal GDP. I realize that this borders on wishful thinking. But a first small step in the right direction can still be expected this spring. Even very long journeys always begin with a first step.

24. **As the Damocles sword of Greece is removed from over the euro over the next month or two, investors will probably adopt a more benign view of the euro exchange rate.** Since everybody who matters in foreign exchange markets seems to be short the euro, the rebound can be swift and significant.

25. **Once the dust settles after the end of the Greek crisis, Portuguese, Italian and Spanish bonds will probably rally**. Their ten-year yields are 2.51, 1.65 and 1.49%, respectively. For the more courageous, Greek 2% bonds due in 2024 are worth a look – they trade at 65.95 and will be repaid at 100. Note that the risk of a euro depreciation has declined considerably over the past year which lends support to those bonds from the periphery. The euro may fall further, but most of the decline should be behind us.

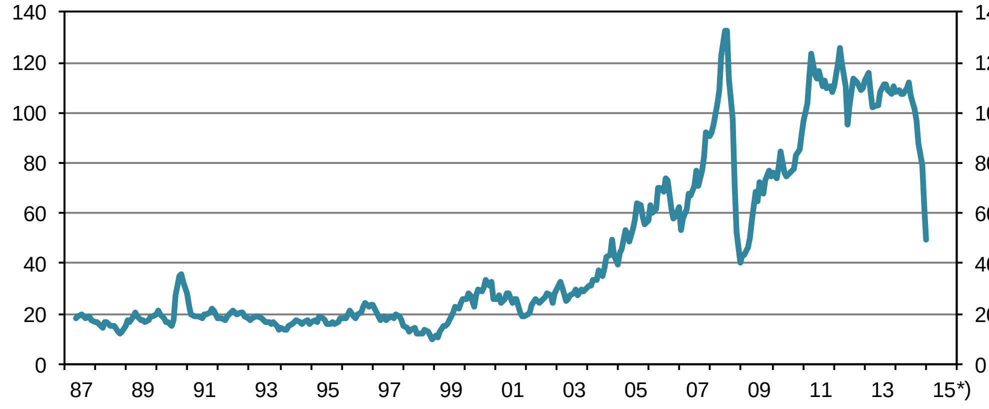
low oil prices stimulate the economies of oil importers

26. **If the oil price stays where it is – under $50 per barrel of Brent today -, or declines even further, the effects on the structure of the world economy and many business models will be profound.** The truth is that no one knows where it is heading, except for the Saudis who continue to be the swing producers and thus hold the key for the whole market. Another

truth is that there is no single oil price level that might be called equilibrium. 40 dollars, 70 dollars, 115 dollars or 140 dollars? All is possible.

oil price

– Brent, dollars per barrel, monthly averages –



*) January 19, 2015

source: Thomson Reuters

27. **For a while it seemed that an equilibrium range had been found: for three and a half years, from February 2011 to July 2014, the oil price fluctuated between 100 and 120 dollars.** Hardly any analyst regarded this as an unusually high level. The main assumption was that if the range were to be given up, it would be on the upside. But in fact, an average oil price of 110 dollars was extremely high – in the 20 years to January 2004 the average had been just 21 dollars. So the price increase over the following seven years was no less than 424 percent, or 26.7 percent a year. By any standards, these were clearly frothy rates. **An oil price bubble had formed that was interpreted by market participants as an equilibrium, the longer the range held.**

28. On the **supply side**, exploration was intensified, including in very inhospitable areas such as the Arctic and the deep seas; the US and Canada experienced oil shale and fracking booms. Expensive production made sense as long as the oil price remained high. But what if not? **High prices had predictable effects on the demand side as well**: energy efficiency was improved in great strides, people tried to drive less, buy smaller cars, insulate their homes and install state-of-the-art burners; and demand shifted from fossil fuels to renewable energy from wind and sun. In other words, markets worked as they are supposed to work.

29. **Once the oil price began to slide, back to more normal levels, there was no stopping it. Almost all production facilities are characterized by very low marginal costs; in Saudi Arabia they are below $5 a barrel, and even in Russia not much above $20. As long as prices exceed marginal costs, it makes sense to keep pumping.** And Saudi Arabia had an additional motive to keep the taps open: by making oil more affordable again, it hopes to stop or slow the development of alternative sources of energy, reaffirm its role as the key player in the global energy market and make itself indispensable for the US - a way to get protection against radical Islam.

30. **As the oil price comes down, marginal producers are leaving the market and reduce the supply of oil.** Unless there is a quick and significant rebound, more and more will go bankrupt as they are unable to service their debt at the much lower levels of revenue. If prices stay where they are now, the whole shale oil industry is not viable any longer. Similarly on the demand side: suddenly it is once again fashionable to drive big cars. Air travel could become very cheap. Electric cars which are already unattractive in purely economic terms make even less sense and will de facto be loss-making propositions for the producers.

31. **Cheap oil will also slow the development of renewable energies from wind and sun. And it is very bad for the environment**. Incidentally, a sensible policy response would be to raise taxes on the consumption of fossil fuels – in order to maintain incentives for energy efficiency – and simultaneously reduce rates at the lower and middle ranges of the income tax schedule. This would not only be neutral for private consumption but also reduce the dependence on imported oil and gas. Especially for the euro area this is an intriguingly plausible strategy.

32. **In any case, just as on oil's way up, there will be countervailing forces on the way down. Supply will shrink in response to low prices, and demand will increase, also in response to low prices.** This is of course a pretty vague statement. To put things into perspective, let me point out that in 2008/2009 the oil price declined by four fifths from peak to trough. A similar pattern this time would result in a lower turning point at $23, followed by a quick recovery. On the other hand, I think an oil price of, for instance, $60 is still fairly high. It would imply an average annual increase of somewhat more than 10 percent since 2014 which is well above the growth rate of global nominal GDP during that time.

33. In general, after the many breakthroughs on both the demand and supply side it seems to me that **the term "energy glut" better describes the present situation than the term "scarce energy"**. There is certainly nothing to suggest that the world is close to the once popular "peak oil" point.

34. **It is obvious that carbon assets are no longer what they used to be.** Prices have already declined a lot in response to falling revenues, but also in anticipation of major write-downs. I expect a new round of mergers in the global oil industry. On the other hand, the alternative energy industry is facing an uphill struggle that could last several years – its survival strategy must consist of pushing for further technological breakthroughs in production, transmission and storage, plus cost cutting.

why stock markets have been holding up so well

35. Finally, a word about the stock market. **Equities have done quite well in recent years, unimpressed by the prospect of deflation (which is bad for profits) and the sluggish growth of the world economy.** At this point, global real GDP expands at an annualized rate of 2.9 percent if actual exchange rates are used for calculating country weights, and at a rate of 3.4 percent on a purchasing power parity (PPP) basis. This is not only quite a bit less than in the

decade before the financial crisis, it is also too slow to fill the large output gap. Price competition is fierce and will remain fierce which means that profits will mostly come from larger volumes and cost cutting, not from wider margins.

36. **The main reasons stocks are doing so well are easy monetary policies and booming bond markets.** Since bonds have become so expensive, and yields so low, stocks began to look cheap, especially those with high pay-out ratios and a history of rising dividends. In Switzerland, 10-year government bonds yield -0.07% today! Investors must be betting on a further appreciation of the Swiss franc. Good luck to them. I wonder why they are not buying Swiss stocks which have a dividend yield of no less than 3.45% and a reasonable 2015-earnings p/e ratio of 15.0. The Euro Stoxx 50 also looks quite attractive, with a dividend yield of 3.63% and after a large euro depreciation and thus a reduced risk that it will fall much more from here.

37. **The darling of investors last year had been the US stock market. But it is quite pricey by now.** Average dividend yields are just 1.99%, the p/e ratio has climbed to a lofty 16.6, and the market value exceeds the book value by a factor of 2.73. In other words, stock prices contain plenty of optimism, perhaps also the expectation that the dollar exchange rate is on a secular uptrend by now. I am skeptical, because neither the unfolding deflation scenario nor the loss of price competitiveness in the wake of the dollar appreciation bode well for US profits.

38. Could be that valuations are so rich for some other, irrefutable facts: **the US is the ultimate safe haven for financial assets,** medium-term growth will probably be considerably higher than in Europe or Japan, the country is brimming with innovative ideas and creates more world-beating firms than any other, it has a pragmatic central bank that is also committed to full employment and certainly not constrained by Maastricht rules, and it issues the main reserve currency. All this may justify the premium investors are willing to pay for US financial assets.

39. **What is the cheapest market today? Russia, as you may have guessed.** The 2015 price-to-earnings ratio has fallen to just 2.95 which means that the S&P 500 is 5.6 times more expensive than the average Russian stock. I do not know what to make of RTSI$'s dividend yield of 4.74%, one of the world's highest. Since inflation is 11.4 percent, this is a negative real yield – so buying Russian stocks would be a bet that the rouble does not depreciate any more. Could this happen? Of course – when the oil price recovers. The rouble has already fallen from 34 per dollar last summer to 65.0 today. Most of the depreciation should be behind us, just as most of the oil price decline. But it would be a very courageous bet, not least on the good behavior of Mr. Putin.