WEBLOG

Wermuth's
Investment Outlook

March 2015

ZEIT online • HERDENTRIEB
blog.zeit.de/herdentrieb/

Wermuth's Investment Outlook

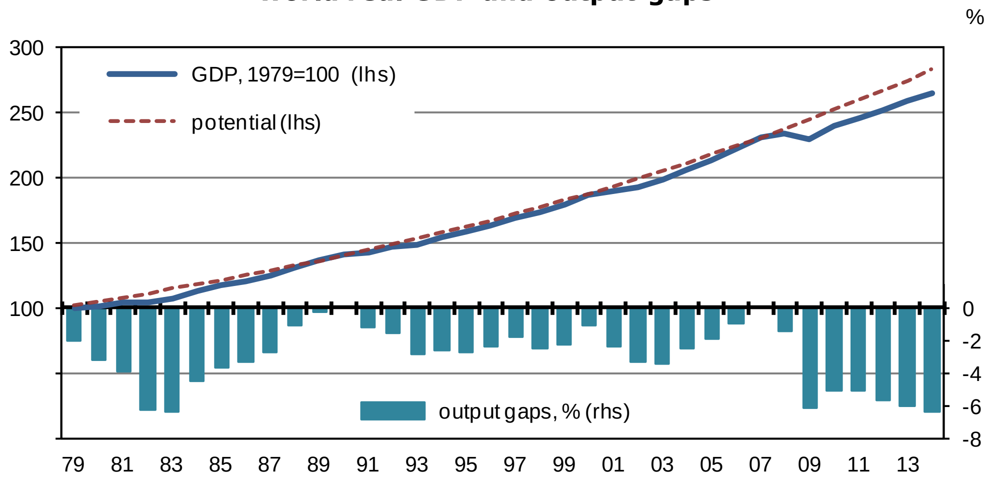
March 6, 2015

Some Green Shoots

by Dieter Wermuth*

1. **Deflation is still a major issue for financial investors but it has recently become less likely that it will turn into a long-term global phenomenon.** Output gaps are still very large, especially in the euro area and Japan, but they seem to have shrunk in response to aggressive monetary policies and adjustments of exchange rates and other asset prices. As the following graph shows, if the 35-year trend of 3 percent world real GDP growth would indeed have persisted to this day the output gap would still be worryingly large.

world real GDP and output gaps*)



*) at market exchange rates; slope of trendline: 3.0% pa

sources: International Monetary Fund; own calculations

2. There is some evidence, though, that the combination of the financial crisis and the deep recession it triggered has caused a **break in the time series**. Potential GDP growth may have slowed significantly, implying that there **may be less slack in the world economy than had been thought – and thus a smaller risk of persistent deflation.**

---

* Dieter Wermuth is a partner with Wermuth Asset Management GmbH and regularly contributes texts to the HERDENTRIEB weblog which is available on the ZEIT online website.

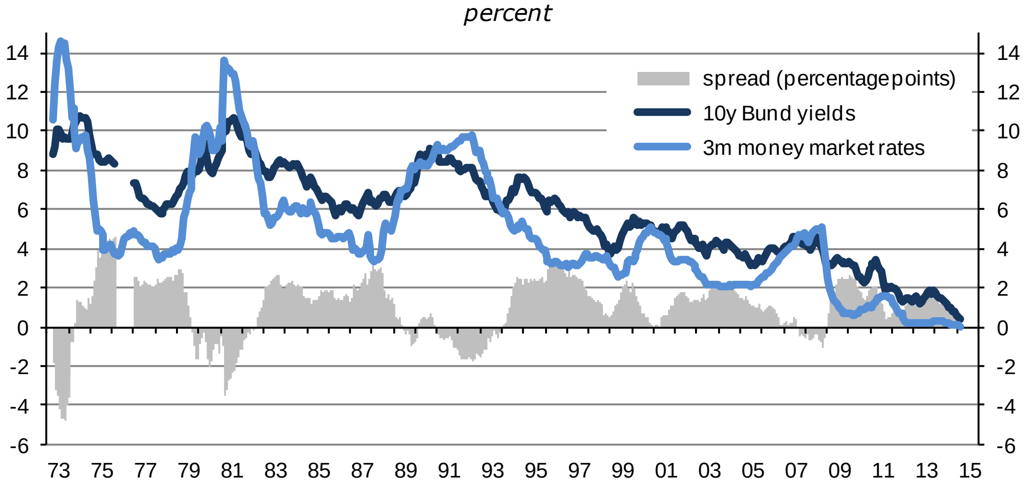
Evidence of slower potential GDP growth

3. What has happened? **Two of the previous drivers from the private sector have fallen to the wayside: real estate and financial services.** At their pre-crisis heyday they had accounted for 10 to 25 percent of total value added. On the basis of boundless optimism and borrowed funds they had developed asset price bubbles which popped in 2008 when market participants realized that the assumptions about future returns were unrealistic. Deleveraging became the defining feature in the following years, ie, the attempt to repair balance sheets by spending less, saving more, selling assets and reducing risks.

4. Banks, in turn, were forced by regulators to boost their equity buffers, to stay away from speculating with clients' money and stop rigging money and foreign exchange markets. Not only that, the combination of near-zero money market rates and falling interest rates on longer-term loans and bonds has dramatically reduced interest margins, previously a key source of income for the banking sector. As profitability shrank the **financial sector became a drag on underlying growth** – just as the housing markets which suffered from an oversized inventory of unsold homes, the legacy of the previous bubble.

shrinking interest margin in Germany

percent



source: Deutsche Bundesbank

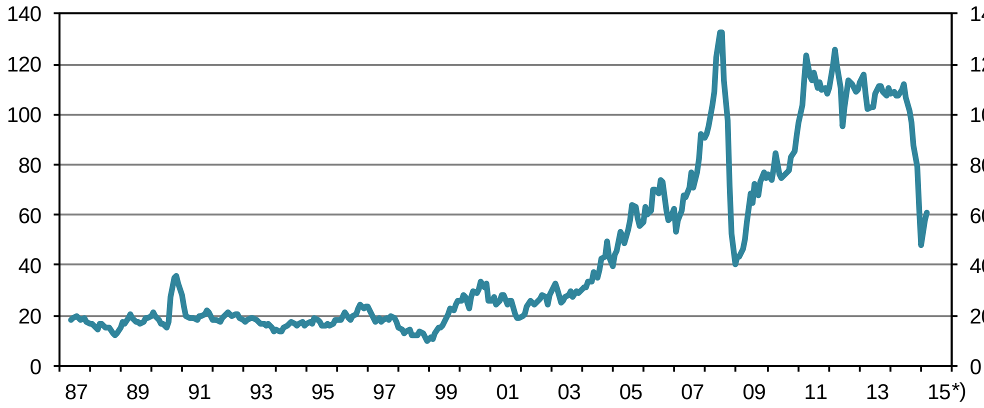
5. **Government finances were another important victim of the financial crisis.** Since politicians and academics regarded – and still regard – banks and insurers as central elements of any market economy, governments intervened, at taxpayers' expense, before they collapsed under the burden of non-performing loans to the real estate sector. The enormous costs of these so-called bail-outs, or rescue operations, pushed many fiscal deficits and debt levels into stratospheric regions. In order to get them back to "normal" resulted in pro-cyclical belt-tightening strategies. In general, while restrictive fiscal policies continue to be with us, they have become less ambitious recently. The worst seems to be over. This is one of the green shoots that suggests to me that the risk of deflation has decreased somewhat.

6. So especially in the rich countries, it's a whole new economic environment. **Previous drivers of growth – housing, finance and the government – have weakened significantly, without any replacement in sight at this point.** The retail trade is also shrinking fast. Add to this that

China, the world's main growth engine so far, is in the middle of a structural change which is slowing its expansion; the shift is from the unsustainable emphasis on capital spending to household consumption.

oil price

Brent, dollars per barrel, monthly averages



*) March 6, 2015

source: Thomson Reuters

7. **A recent newcomer to the sectors which are undergoing massive structural changes – and thus slowing global growth – is fossil fuels.** For about four years, until the summer of last year, oil prices had been at elevated levels of $100 to $120. The widespread expectation that they would stay there for longer, or rise, had led to massive investments in the exploration, production and distribution of oil and its substitutes, and an oversupply. It became known as the **carbon bubble**. Now that prices have fallen to about $60, many of the marginal market participants have to stop their activities. Capital spending in that sector is being reduced as firms find it more profitable to rely on existing capacities. The fossil fuel sector is shrinking and its weight in global value added has probably been reduced for good.

Smaller output gaps, less deflation risk

8. **It is therefore highly likely that the world economy will not be able to achieve its earlier global trend growth rate of 3 percent anymore** (actual exchange rates). Barclays, the investment bank, estimates that the new "normal" is 0.9 percentage points per year less than before 2010 (Global Macro Daily, 2 March 2015, p. 2-3). Recent OECD numbers confirm this estimate.

9. In other words, average actual and expected post-crisis global growth of about 2.7 percent a year (2011 through 2015) has been, and is, somewhat higher than the **new trend rate of 2.1 percent** (actual exchange rates). **The output gap, while still very large, would be smaller than the one shown in the graph on page 1. And it may be shrinking faster than I used to assume – which would reduce the deflation risk correspondingly**.

10. **If this is so, I would expect dramatic consequences for capital markets.** Central banks in rich countries would give up their extremely expansionary policies earlier than expected today – including zero policy rates and quantitative easing –, bond yields would rise in synch

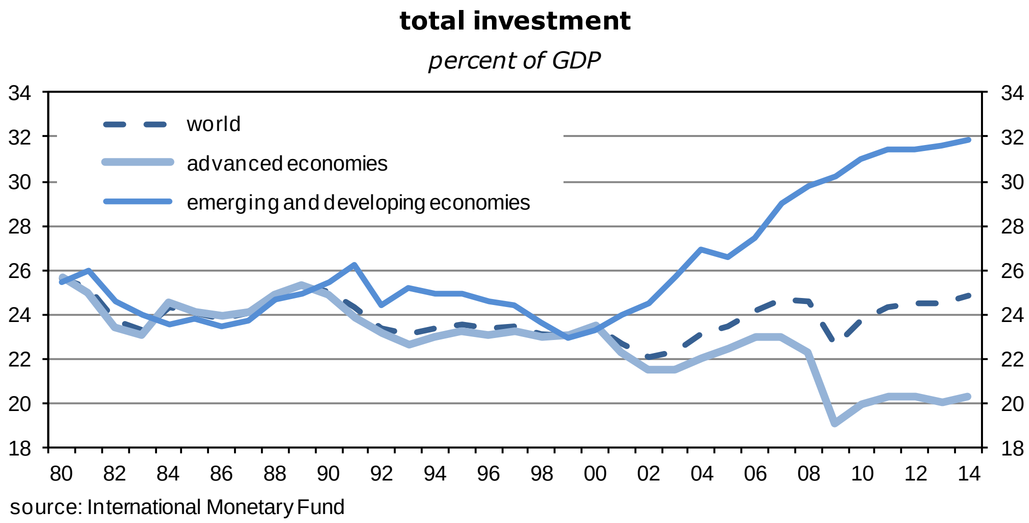
with rising inflation expectations and drive down the market value of bond portfolios, stock markets would lose their appeal as substitutes of fixed-income securities, ie, fall a lot or crash, exchange rates would no longer be determined by the expected growth of central bank money (central bank balances), commodity markets would rebound, and so on.

After the end of deleveraging – higher growth rates again

11. **The question is whether there has indeed been a structural break in the composition and dynamics of global growth.** We know that financial crises, caused by the popping of asset price bubbles and followed by widespread debt reduction strategies ("deleveraging"), are very hard to overcome. Standard demand-boosting policies are less effective than in normal recessions (see Reinhart & Rogoff: *This Time Is Different*). It is **not really surprising that GDP growth will disappoint for longer than after previous cyclical downturns.**

12. **But does this imply that global trend growth has declined for good?** After the end of the last major financial crisis, the depression of the thirties and the Second World War, global growth became quite brisk again and remained high for several decades. I don't see a plausible reason why productivity and employment growth, the two components of potential GDP growth, should not pick up again after the end of the present deleveraging process. The internet in particular has probably a large untapped potential for productivity gains. It changes value-adding chains as well as consumption patterns. Something new will arise from the ruins, so to speak.

13. **The next graph shows that the global investment ratio, a determinant of productivity growth, has held up quite well in recent years. Capital spending remains robust.**



14. **Perhaps the most likely scenario is slow economic growth for some more years, accompanied by shrinking output gaps, an acceleration of inflation and tighter monetary policies, followed by a pick-up in capital spending, productivity growth - and GDP growth in general.**

15. **In the following, I will look for evidence that deflation has indeed become less of a risk.** For the world economy as a whole, key indicators of demand and supply imbalances suggest that there is still plenty of slack and therefore a non-negligible deflation risk.

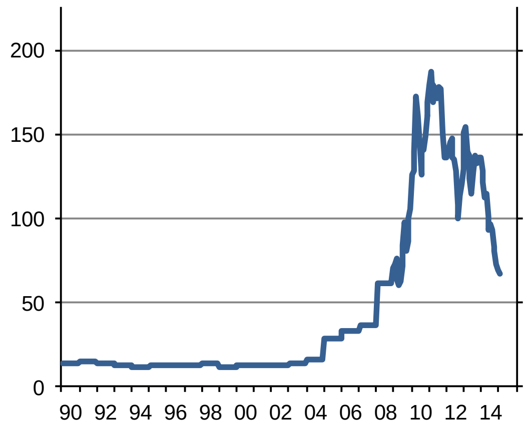
Commodity prices: most of the decline lies behind us

16. **The oil price may have rebounded from its mid-January low by almost one third (from $46 to $61, for Brent), but so far it is too early to bet on a genuine reversal**. Profit taking by speculators is a better description of what has happened. Capacity and supply reductions in response to low market prices have probably played a role as well. The rebound was strong enough to push up February consumer price inflation across the rich world – even though it stays near record-lows in year-on-year terms.

17. Some commodities, such as copper or aluminum have also recovered part of their losses after last year's crash, but others continue to lose ground, for instance iron ore, nickel, tin, corn, wheat or coffee. Elevated prices during the boom years had boosted exploration and production which then led to oversupply. **Looking at broad commodity-price indices suggests that most of the decline lies behind us but that there are no signs of a new inflationary momentum.** Gold which is considered, together with real estate, as the best inflation hedge, continues to lose ground – in spite of extremely low interest rates (and thus zero opportunity costs of holding gold). Here the message is that inflation is not a risk that warrants a hedge.

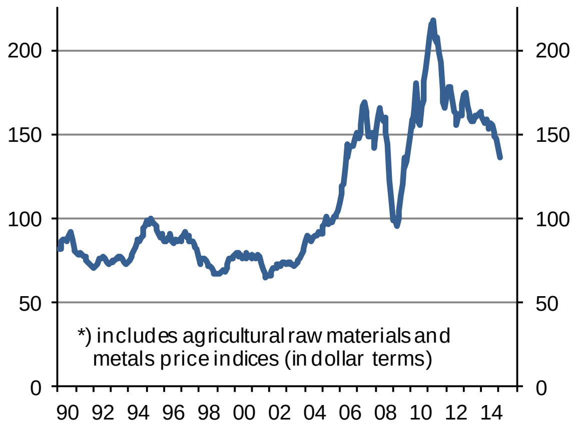
iron ore

US$ per metric tonne



commodity prices*)

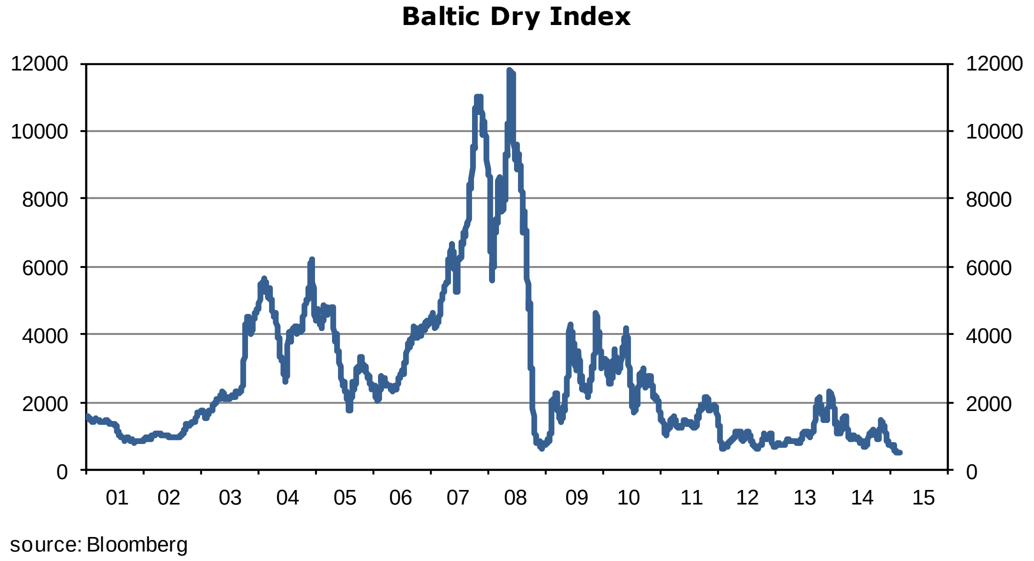
2005=100



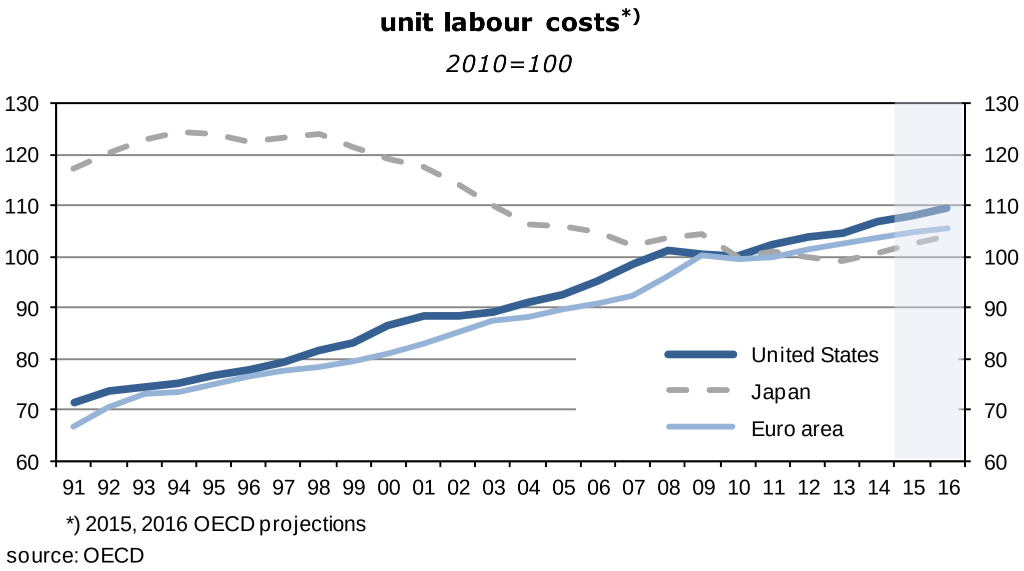
source: International Monetary Fund

18. Raising prices is usually easiest when the world economy is doing well. On the basis of actual exchange rates, first quarter growth of global real GDP is probably in the order of 2.5 percent annualized (US 2.5%, euro area 1.6%, China 6.3%, Japan 2.8%), somewhat higher than the "new" potential GDP growth rate of 2.1 percent, but low compared to pre-crisis rates. As usual, world trade expands at a multiple of GDP growth. At this point, the multiple is still rather modest (about 1.6 times). **A robust self-sustaining economic expansion and an acceleration of inflation on a global scale are still some time off, it seems.**

19. **Freight rates remain depressed.** The Baltic Dry Index which is a composite of the Baltic Capesize, Panamax, Handysize and Supramax indices hovers near its historic low (and -57% y/y). Price competition among shippers for international business has never been as intense as today. This continues to promote the division of labor across countries and continents and reduces the scope for price increases. World trade is the most powerful weapon against inflation. It allows consumers and business in advanced countries to participate in the large productivity gains that are typical for emerging economies which are in the process of catching up. Since shipping is so cheap, international competition will remain intense and exert downward pressure on inflation.



20. In national production functions, labor plays a significantly larger role than the two other inputs, capital and imports. **Inflation is therefore unlikely if the so-called unit labor costs (ULC), ie, wages adjusted for productivity, remain subdued**. This is certainly the case in **Japan** where the last reading of ULC was -0.5% y/y. Cash earnings were rising by less than productivity. Employment has gradually declined for almost 20 years and has put Japanese workers in a precarious position in wage negotiations.



Fed can afford to raise interest rates

21. **In the US, the situation is very different**. ULC had increased at an annualized rate of no less than 4.1% in Q4. Labor market conditions continue to improve. In February, the unemployment rate may have fallen to 5.5 percent and thus significantly below the level that was considered to signal full employment not long ago. Payrolls had been up 2.2% y/y in January and seem to expand at ever faster rates. Yet average hourly earnings have increased at a relatively modest rate of only 2.0% between January 2014 and 2015 (probably +2.1% y/y in real terms). American workers have not been able to get large pay rises – it could reflect the dollar appreciation, ie, strong international competition, or the fact that participation rates are still depressed. A closer look thus shows that not all is well in US labor markets.

22. Incidentally, this also applies to productivity: if ULC rises so much faster than wages, it means that productivity is declining steeply. For a recovery, and given that real equipment investment has been expanding at rates in the order of 8 percent, this is quite unusual.

23. **In any case, aside from unit labor costs, US inflation is not yet accelerating**. Import prices have been down no less than 8.0 percent y/y in January. The PCE core index which is Fed's favorite inflation gauge, had been up just 1.3 percent y/y in January and thus well below the 2 percent target. Or take the GDP price deflator: in Q4 it was a mere +1.2% y/y and 0.0% q/q, or headline CPI, at -0.1% y/y in January. Quantitative Easing no. 3 had ended last October while the dollar has been extremely strong: together these two events have a significant restrictive effect on US demand and thus inflation. The Fed is actually under no particular pressure to raise interest rates this summer.

24. But markets expect that it will happen anyway, simply **because the US economy is doing so well and because the long period of zero policy rates (since December 16, 2008) has to end at one point; the Fed funds rate should not lose contact with the real economy - which has begun to take off by now.** Real GDP is expected to move along at growth rates in the order of close to 3 percent. Driver number 1 is household consumption, the most important

component of demand; it benefits a lot from the strong growth of both employment and real wages and may expand at an annualized rate of about 3 percent in the present quarter and beyond. Driver number 2 is capital spending which is advancing at more than twice that rate. Overall demand is dragged down by the stagnation of public spending and negative net exports. On balance, the risk that tighter monetary policies will kill the recovery or cause deflation appears to be small. So the Fed will soon begin to raise rates.

25. Investment bank Barclays forecasts that **the Funds rate** will initially be increased by 25, and then by 50 basis points per quarter, to reach **2.5 – 2.75% at the end of 2016**. This looks reasonable to me. Bond yields will also rise, if by less than money market rates - inflation expectations will probably remain low and stable.

26. For investors, the coming of a flatter dollar yield curve is a **signal to reduce the duration of their bond portfolios. US stock markets, not exactly cheap for quite some while, will also come down in the wake of the Fed's policy shift.** They had been a popular substitute for overpriced bonds and have hugely benefited from the Fed's liquidity bonanza. Both effects are about to disappear.

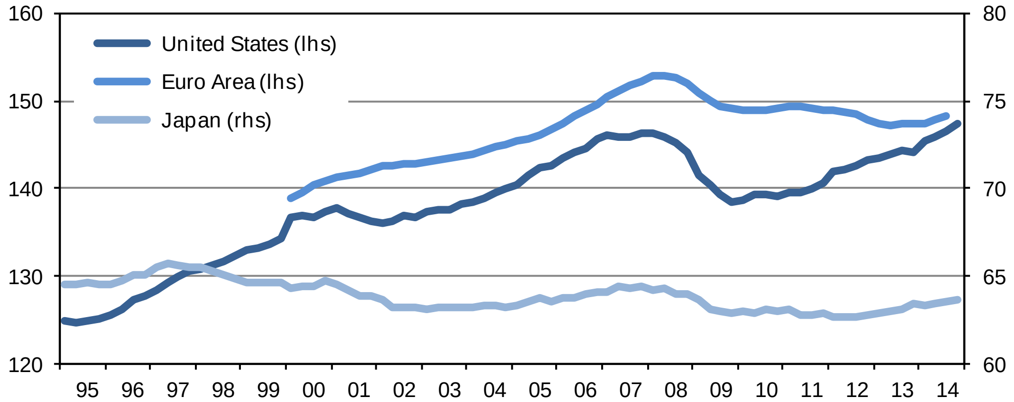
27. The **remaining deflation risk in the US has to do with the dollar exchange rate**. If the rest of the world economy does not catch on to American economic growth, monetary policies will diverge considerably – rising interest rates in the US, low and falling rates, combined with quantitative easing, in other countries. The dollar rally would then continue and reduce US import and export prices so much that America's overall price level could decline; deflation could be a possibility again. The US yield curve would invert.

Euro area economy responds to stimulus

28. The main question in this regard is how long it will take the euro area to achieve self-sustaining growth which increases employment and raises inflation expectations and actual inflation rates. At this point, average unemployment is still 11.2 percent, headline consumer price inflation is -0.3 % y/y and core CPI is +0.6% y/y. In other words, capacity utilization is extremely low, and deflation has arrived.

employment in three economies*)

million persons



*) seasonally adjusted

sources: Eurostat, Federal Reserve, MIAC-Statistics Bureau

29. But the **likelihood of stronger growth and rising inflation rates has increased significantly** in recent months:

    - The exchange rate of the euro is almost in a free fall. This has strengthened the international competitiveness of the 19 member states. It also reduces the risk of deflation.
    - Collapsing oil prices have given an unexpected boost to the purchasing power of households and firms.
    - Fiscal policies will be broadly neutral rather than restrictive; lower-than-expected fiscal deficits give governments some leeway for more expansionary policies.
    - The ECB will flood the economy with central bank money until inflation is close to 2 percent.
    - Germany's real GDP is expanding at quarterly rates of about 0.75 percent.

30. According to the new staff projections of the ECB, **euroland's real GDP will expand by 1.5 percent y/y in 2015 and 1.9 percent in 2016.** There are even signs that employment is finally increasing, at rates of almost 1 percent in both 2015 and 2016 so that the unemployment rate can come down somewhat faster than over the past two years and fall below 10 percent in the course of 2016.

31. **In a fundamental sense, the euro is quite sound**. The current account balance of the euro area will be in surplus to the tune of 2.7 percent of GDP, compared to a US deficit of 2.3 percent. The ECB also expects that the aggregated general government budget balance as a percentage of GDP will decline to 2.3 in 2015 and 1.9 in 2016 – much better than required under the Maastricht provisions and smaller than the US deficits. **While the starkly different policy stance of the Fed and the ECB will probably drive down the euro even further, perhaps to parity, the forces that will pull it back up again are getting stronger as well.**

32. **One good sign are the recent wage settlements in Germany of about 3½ percent. Employment had been growing at annual rates of close to 1 percent since 2009. Disposable incomes had already been up 3 ½ percent y/y in Q4 and will soon increase at a rate of about 4 percent** – in real terms things are not much different. People have more money to spend than they had expected. So household consumption has turned into the driver of German growth – in January, real retail sales had been +5.3 percent y/y! Capital spending is still subdued but will catch on once firms see that sales have been picking up for good. Predictably, exports are booming in spite of the lackluster performance of world trade. Imports are also expanding briskly. Another good sign is that German politicians are now discussing how to boost spending and to cut taxes – the large budget surplus is stimulating a lively discussion in this respect, finally.

33. **Since euro area GDP now expands faster than potential GDP, the output gap is shrinking which reduces the risk of deflation**. Market participants are not yet convinced that the ECB's expanded asset purchasing program (which starts on March 9) will indeed succeed in raising final demand and inflation rates. They are making a mistake. Purchasing bonds in the order of €60 bn per month will continue until inflation is near 2 percent, and even beyond the present end date September 2016 if the target has not been reached by then.

34. **I am surprised that bond yields have responded so little**. Two effects pull them in opposite directions: the bond purchases drive up bond prices and thus lower yields, while the communication of the ECB - that they will not let up before inflation is much higher than today – depresses bond prices. The latter has not happened yet. German 10-year government bond yields are at 0.35% and thus still close to their all-time low. The same holds for Dutch (0.40%), French (0.64%), Italian (1.26%), Spanish (1.23%) and Portuguese (1.69%) bonds.

35. **As a minimum, I suggest that the yield spreads between these countries, which can all safely be expected to stay in the currency union, will decline further**. Greece is an unresolved issue but on the basis of what I know about Europeans' ability to compromise I would be very surprised if the country were to be kicked out of the currency union or leave it on its own.

36. **But I also believe that in the end bond yields have to rise a lot**. The ECB cannot stop its expansionary policies before inflation has reached something like 1.8 percent. Keep in mind that there are no limits to the amount of money an independent central bank can create. I have no idea, though, when this yield turn-around will happen.

37. It may come earlier than market participants expect. It is **worth keeping an eye on developments in US bond markets** because they are traditionally a driver of bond markets in the rest of the world, not least of European markets. These are considered to be close substitutes. 10-year US Treasuries are presently at 2.12%. Once they reach, say, 2.5%, market professionals will take notice and start to sell euro area bonds. This would also be a signal to take profits in stock markets – and to go long the euro in FX markets.