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Wermuth's

Investment Outlook

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Low interest rates are here to stay

by Dieter Wermuth*

1. **Investors must closely monitor the effects of three recent developments: large movements in exchange rates, in particular the huge appreciation of dollar and yuan and the simultaneous depreciation of euro and yen, the collapse of oil and other commodity prices, and the slowdown of the Chinese economy in combination with popping stock and real estate bubbles there. Will all this continue? And when will real interest rates begin to rise again?**

2. **On the face of it, the world economy is in good shape**, with real GDP expanding at a rate of about 3 percent, robust employment growth and average consumer price inflation of 2 percent. But a closer look shows that **growth is threatened by a number of imbalances.**

3. In its new annual report, the BIS, the Bank for International Settlements lists the following:

   - debt burdens remain high in absolute terms and relative to output and incomes;
   - some countries hit by balance sheet recessions are still struggling to return to healthy expansion;
   - in many others, financial imbalances in the form of strong credit and asset price increases are building up;
   - monetary policy has taken up far too much of a burden of boosting output;
   - productivity growth has continued to decline.

4. In addition to the risk that one or several of these imbalances will unwind in hard-to-forecast ways, **investors are faced with expensive equity markets and very low, sometimes even negative real interest rates on fixed-income securities. In liquid markets where benchmark securities are traded the risk/return trade-off has been unusually unfavorable for some time now.**

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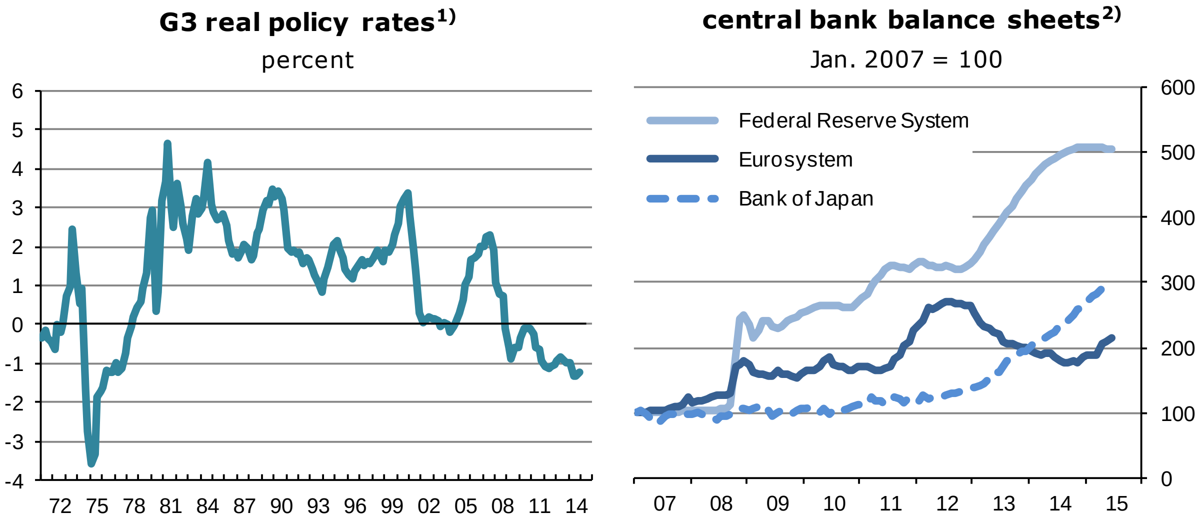
* Dieter Wermuth is a partner with Wermuth Asset Management GmbH and regularly contributes texts to the HERDENTRIEB weblog which is available on the ZEIT online website.

5. To earn decent returns, **savings should therefore be directed towards riskier assets** such as real estate in undervalued jurisdictions, neglected small-country stock markets, infrastructure projects such as public private partnerships, participations in private equity and hedge funds, or government-sponsored green energy programs. To be sure, such assets are usually either fairly illiquid or risky, and they also require significant and costly analytical efforts. But the trend towards lower-rated investments is well-established by now. As the BIS shows on page 115 of its annual report, insurance companies in both the euro area and North America have increased the share of such investments in their securities portfolios from roughly 10 percent in 2008 to 30 percent last year.

6. One problem that must be addressed at the outset is the **level of short-term and long-term interest rates. They are clearly well below the levels once considered to be normal.** Does this mean they are about to rise? In which case durations should be reduced aggressively. I don't think so, with the exception of dollar rates.

Central banks create asset price bubbles

7. Since inflation is so low – even in China it was just 1.4 percent in June – most central banks pursue extremely expansionary strategies, reflected in **negative real policy rates and rapidly inflating balance sheets.** Policy makers equate low inflation with the existence of considerable slack in the economy and are determined to keep the foot on the accelerator as long as capacity utilization and thus inflation stay below normal.



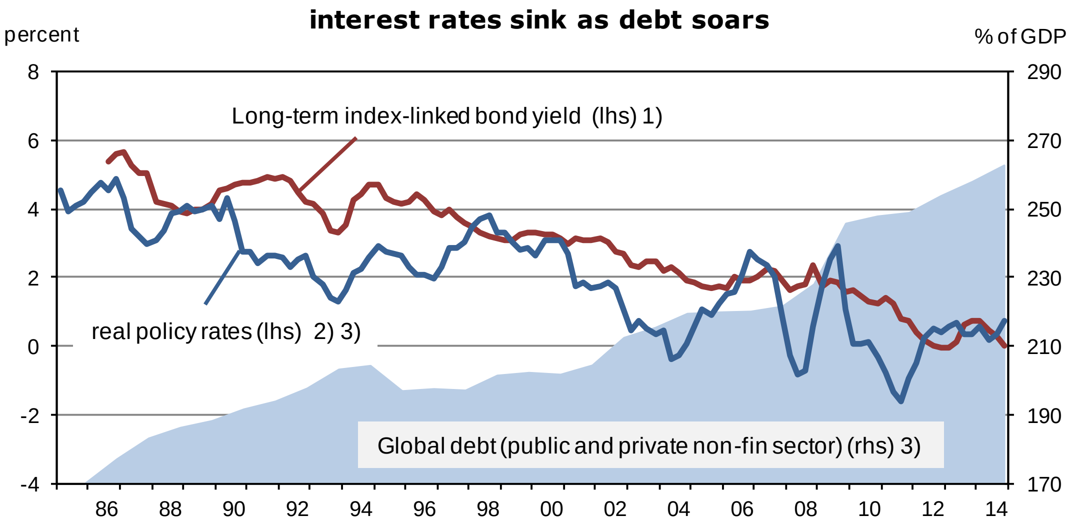
1) Nominal policy rate less consumer price inflation excluding food and energy. Weighted averages for the euro area (Germany), Japan and the United States based on rolling GDP and PPP exchange rates. - 2) total assets

sources: BIS, Federal Reserve, ECB, Bank of Japan

8. The strategy does not quite work, though, or not as well as expected. In general, **private and public debt levels remain very elevated**. Potential borrowers often feel uneasy about the effects of this on their credit rating and give a high priority to the reduction of their existing debt. This is called "deleveraging" – they don't like to increase their debt burdens. The monetary transmission mechanism breaks down in such a situation.

9. Besides, capital expenditures and the creation of new jobs depend primarily on sales expectations and not so much on interest rates or access to credit. Most central banks in the OECD area are therefore de facto pushing on strings. **Easy monetary conditions are appropriate in the present environment, but not enough to get the economy going and to raise inflation expectations. Easier fiscal policies and measures which enhance productivity growth in the medium term must also be part of the policy mix. This is lacking.**

10. While easy monetary conditions may fail to stimulate the real economies they are likely to create asset price bubbles, ie, financial instability. Policy makers rarely try to deflate these bubbles at an early stage, even though they possess the analytical tools to detect them. When inflation rates are well below targets, it is politically difficult to tighten the monetary and regulatory reins – which invariably means that the bubbles become very big and then burst one day, pushing the economy into recession. As a result, inflation would typically decline again and prompt central banks to launch another round of monetary stimulus. **For the BIS, "low rates beget lower rates."**



1) From 1998, simple average of France, the United Kingdom and the United States; otherwise only the United Kingdom. - 2) Nominal policy rate less consumer price inflation. - 3) Aggregate based on weighted averages for G7 economies plus China based on rolling GDP and PPP exchange rates.

source: BIS

11. **The bottom line for investors at this point is that central banks in rich countries, with the exception of the Fed, will keep policy rates close to zero for some time, at least for a year. By extension, as long-term rates are the product of expected short-term rates, bond yields will also stay depressed**. Taking profits after the 30-year fixed-income rally makes sense because further capital gains can only be small given the elevated level of bond prices. But there is no need to rush yet.

Strong dollar, weak euro – the end is near

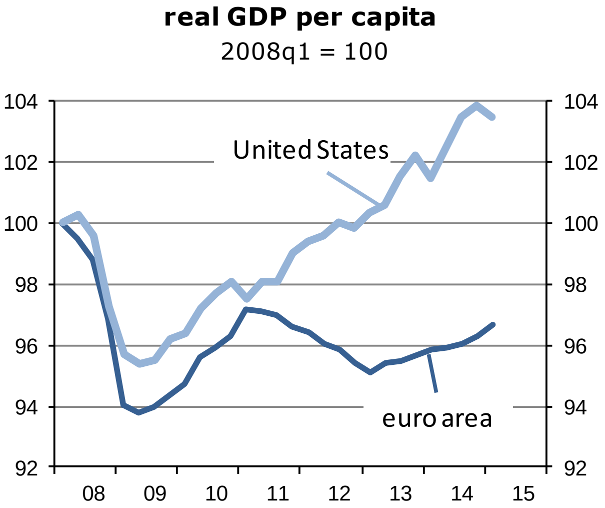
12. **How about the dollar?** In spite of at least two negative fundamental determinants, government and current account deficits, it has appreciated a lot in trade-weighted terms since about May 2014, and also bilaterally against its main competitors - euro and yen. Its secular depreciation against the Chinese currency ended already in early 2014 when it hit its

low at 6.04 yuan – the exchange rate has now been stable at 6.21 for more than three months.

13. **The question is whether the strength of the dollar will continue, and for how long. I see little reason at this point in time for a significant depreciation, even though some adjustment after the likely resolution of the Greek crisis looks likely**. For market participants the euro has lost some of its status as an alternative store of value; the likelihood of a break-up is still very small but no longer zero. The Greek crisis has brutally exposed the currency union's main weakness – the lack of progress towards a political union. This is why fiscal policies largely remain in the domain of the member states. And without a well-endowed and powerful central Treasury, monetary policies are overburdened and don't provide the stability investors are looking for. The corollary to this is that the euro will probably stay structurally undervalued – not a bad thing in the present low-growth environment.

14. The creation of a common central bank and a common banking supervisor, of a bank resolution authority and bail-out funds (EFSF and ESM) have been steps in the right direction, but they are not enough for decisive actions when times are tough, when problems must be addressed by fiscal means. It is now conceivable that countries leave the currency union, against the spirit and original intention of the founding treaty. In other words, **the euro is at risk to become just another non-binding fixed exchange rate system. Unless there is some visible progress towards a political union the currency union would be doomed.**

15. In addition, the **euro area has disappointed in terms of GDP growth and job creation.** The unemployment rate is still at 11.1 percent and has thus barely come down from its 12.1 percent peak in April 2013; youth unemployment runs at a rate of 22.1 percent. Euroland is raising a lost generation. No politician of stature has so far addressed this issue; national rather than euro-wide viewpoints dominate the public debate. The European project is not a vote getter any longer. Some poor countries may hope to adopt the euro, but well-off and well-run countries like the UK, Sweden and Denmark see no reason to apply for membership. Even in Poland and the Czech Republic the public increasingly dismisses the idea of joining the club.



sources: Eurostat, BEA; own calculations

16. As the two graphs above show, **the comparison between the performance of the US and the euro area economies is quite sobering.** The US has been vastly more successful in overcoming the crisis - which may "point to the fact that an incomplete monetary union adjusts much slower than one with a more complete institutional setup in place."

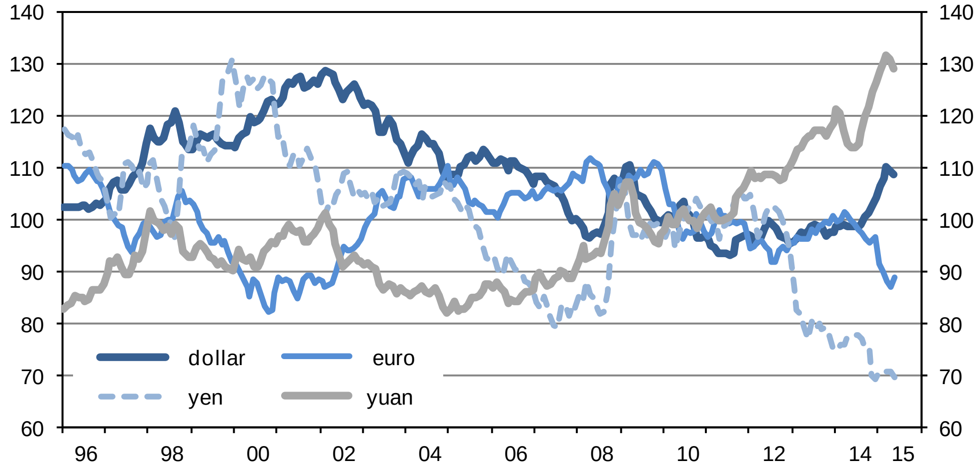
17. **Another support of the dollar exchange rate is the intention of the Fed to raise the Funds rate later this year - whereas the ECB continues to state very clearly that the main refinancing rate will stay at 0.05 percent**, presumably at least until September 2016 when the €60bn-a-month bond buying program ends. In the second quarter of this year, the US economy has probably grown at an annualized rate of 3 percent, compared to euroland's 2.0 percent. For the year as a whole, and also for 2016, the growth difference will remain in favor of the US. For investors the main message is that profits of American firms will rise faster than those of their European competitors. In other words, further significant autonomous capital flows into US stock markets (and other assets) can be expected. The 2½ percent-of-GDP current account deficit can thus easily be financed by capital inflows from abroad.

18. As I have said before, for the euro area, the weak euro is the right medicine at this point and therefore welcome. In spite of the depreciation, import prices continue to fall - which means that **euroland is still importing deflation**. This is not such a good thing as it used to be. With inflation running at 0.2 percent year-on-year and thus far below the target of just below 2 percent, the ECB would prefer to import inflation. At 0.8 percent, core inflation is also well below the comfort zone. A further depreciation of the euro is in the interest of policy makers. With the Greek crisis probably over, they will not get their will, though.

19. **Another policy tool puts downward pressure on the euro: quantitative easing.** While the Fed has given up such a strategy last fall, the ECB intends to continue its bond-buying program until September 2016. On a net basis, it amounts to almost 7 percent of nominal GDP per year. If actual inflation and inflation expectations are still too low in the autumn of 2016, the program will be extended, presumably indefinitely.

real exchange rates

2010=100



source: Bank for International Settlements

20. As I have argued above, easy monetary policies these days, in an environment of very high debt levels, may mainly cause asset price bubbles and do little to stimulate GDP growth and inflation. When those bubbles pop, market participants can expect deflationary effects. In this sense, the ECB's generous creation of central bank money may well be counterproductive. What it does, however, is to increase the supply of euros, and this not only causes domestic (euro area) or commodity bubbles but also a depreciation of the euro exchange rate. **Via the exchange rate detour – which leads to larger net exports, more employment and higher inflation – the ECB may in the end actually succeed to reach its inflation goals.**

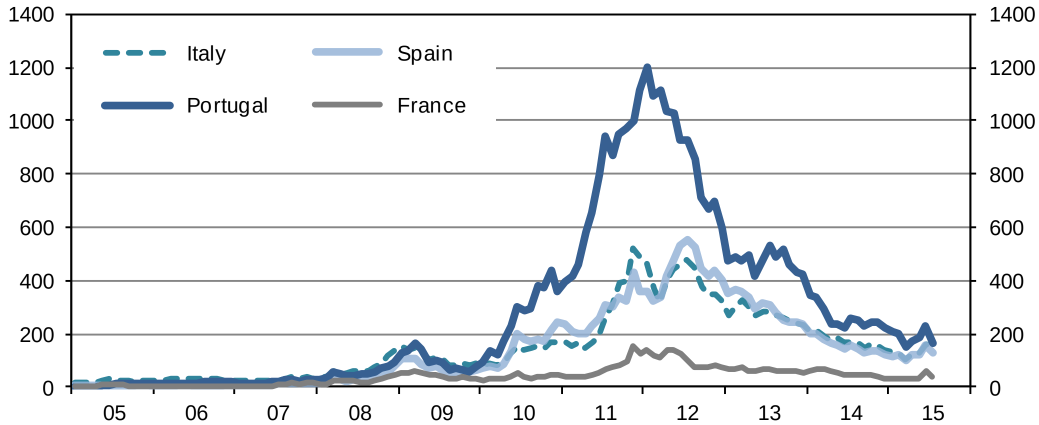
21. It may work because foreign trade plays an unusually large role in the euro area economy: exports of goods and services are no less than 44½ percent of nominal GDP, and imports 40½ percent. Movements in the exchange rate matter a lot more than in the US. That still leaves the question of timing: when will inflation reach its target value? Success in terms of headline inflation is actually not the only requirement for a change in monetary policies: there must also be convincing evidence that inflation will stay at 2 percent or above, that the success will be permanent. **I guess that ECB policies will remain expansionary for at least another year or so.**

Greek crisis likely to be resolved

22. Euro bond yields will be kept low by this. But since the perception of risk has increased over the course of the Greek crisis, **yield spreads** between German, Dutch, Austrian and Finnish bonds on the one hand and Portuguese, Irish, Spanish, Italian and even French bonds on the other hand will probably remain higher than they had been before the financial crisis which began in the summer of 2007.

yield spreads over Bunds*)

basis points



*) 10-year maturities; July 2015 own forecast

source: ECB; own calculations

23. The likely resolution of the Greek crisis this weekend removes one important negative factor. **Greece will not be the next Lehman Brothers.** Once again, European policy makers have been true to form by finding a last-minute compromise: Greece seems to accept the conditions attached to the next instalment of financial help. The crisis has also certainly

sharpened the sense for the shortcomings of the euro's present institutional setup and will probably serve as a catalyst for further progress towards a fiscal and eventually a political union.

24. In the near term, the reduction of the break-up risk will push the euro exchange rate higher, reduce yield spreads at the expense of safe haven borrowers such as Germany, and lower the risk premium on euro area stocks, ie, makes them more expensive. Since the rebound of the euro reduces the price competitiveness of firms**, investors should not bet on a new and extended rally of euro area stocks**: the price-to-earnings ratio of the shares in the EuroStoxx50 index is 20.2, the price-to-book ratio is at 1.54. These are rich valuations. On the other hand, the average dividend yield is an attractive 3.5%, especially when compared to the euro area's inflation rate of 0.2 percent year-on-year.

Japan still struggles to remove deflation risks

25. **The Bank of Japan has been even more aggressive than the ECB in terms of flooding banks with central bank money**. Perhaps as a result, the Nikkei 225 has gained about 150 percent over the past three years, the broader TOPIX about 115 percent. While these numbers suggest the existence of stock market bubbles, prices of houses, the other important class of assets, continue to be more or less flat (this refers to Tokyo).

26. **The effect of quantitative easing on the exchange rate of the yen has also been significant – in real trade-weighted terms it has fallen by no less than 30 percent**. Exports are now rising more than imports, real GDP seems to be increasing faster than potential (whose growth is anemic, though) – and inflation will be around ½ percent this year and next. Deflation has been overcome but it is still a long way before a genuine inflation mentality will take hold. There are no indications of this happening yet.

27. **But: could Japan be a bellwether for euro area developments?** If yes, investors can look forward to a further large euro devaluation, strong European stock markets and little progress on the inflation front. Parallels between the two economies have been striking. I am afraid that I cannot really make up my mind on this argument.

The effects of China's slowdown

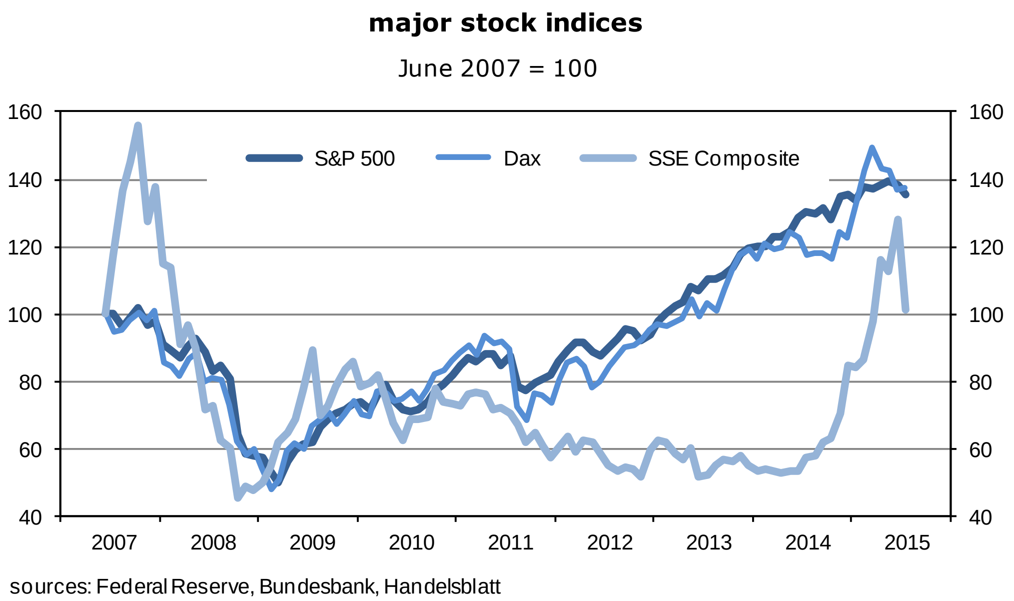
28. **China is now the main mover of the world economy and its markets**. In terms of purchasing power parity exchange rates, its GDP has recently overtaken the US; it has been the largest importer of commodities such as oil, copper, coal or iron ore for some years already. After growing at an average annual rate of 9.8 percent in the 15 years until 2011, growth has slowed every following year – according to the consensus of analysts, real GDP will expand by 6.8 percent year-on-year in 2015. This is still pretty strong, but it is much less than trend growth, and it may actually be too optimistic.

29. Chinese corporate bond defaults are up steeply, as is the share of bad loans in banks' portfolios. Auto sales have been stuttering – in June they were actually down from one year ago -, and **some economists would not be surprised if GDP growth had come to a halt this summer**. In other words, output gaps must be rather large by now and have predictably

reduced the rate of inflation. As mentioned, CPI had been just 1.4 percent y/y in June; industrial producer price "inflation" was minus 4.8 percent.

30. **Not surprisingly either, imports have been very weak**; in the first five months of the year, they have shrunk at an average rate of 17.3 percent year-on-year. Much of this has been due to the decline of commodity prices, but reduced volumes must also have played a role. After all, I see that the average annual rate of increase of Chinese imports had been plus 16.5 percent over the past quarter century. The Chinese economy is obviously in trouble.

31. Note that **the appreciation of the real trade-weighted yuan has been even more dramatic than that of the dollar.** This is another way of saying that the international competitiveness of the country has been dealt a severe blow – and should have led to an import boom. The opposite has happened so far.



32. The **crash of Chinese stock markets** somehow makes sense in light of the deterioration of the economy. But the main reason has been the previous rally, triggered by very easy monetary conditions. Even after the 23 percent fall from the last peak one month ago, the Shanghai Shenzhen 300 index is still 91 percent higher than one year ago. A bubble has popped.

33. More can be expected, in spite of the government's efforts to restrict trading. **Compared to 2008 when the index lost 71.6 percent (between January 14 and November 4), the recent decline is rather modest.** At a price-to-earnings ratio of 17.7 the stock market is not precisely cheap (Hong Kong's is only 10.3); in addition, a price-to-book ratio of 2.44 times also suggests that there is plenty of room for further declines of the index. The dividend yield is a meager 1.53%. Stay away from mainland stocks.

34. What will the stock market crash do to China and the rest of the world? **Since the bubble had been debt-fueled, deleveraging and a slowdown of consumer spending can be expected.** For the time being, the Chinese government must therefore give up its hope to steer the economy away from capital spending and towards private consumption as the

main driver of demand. In the end, it is the consumer who decides how resources will be allocated, not the government.

35. Once the basics in terms of infrastructure, private sector capital stock, institutional setup, qualification of the labor force and international competitiveness have been achieved, central planning must take a back seat. The problem is that consumers, in the wake of significant negative wealth effects, are not yet able to take over - restoring their personal creditworthiness by spending cautiously will soon have top priority for them. **GDP growth will thus slow for several quarters.**

36. **Chinese imports will continue to decline**. Since the country is by no means exclusively focused on commodity imports any longer, countries that export manufactured goods to China will be hit almost as hard as commodity producers. This includes the US and the euro area. China's and Hong Kong's share in euro area exports has reached 8 percent of total exports and somewhat less than 4 percent of nominal GDP. In other words, China plays for the rest of the world economy the role once played by the US – when it sneezes, the others get pneumonia.

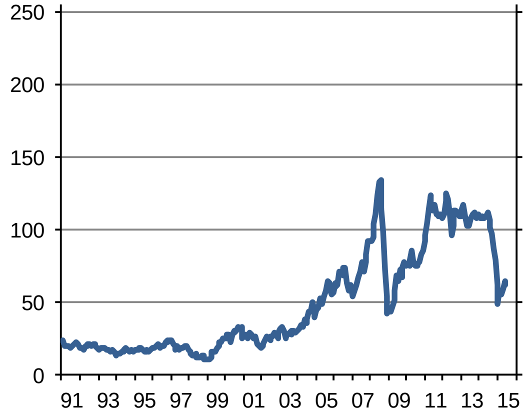
37. **One side effect will probably be to stop the appreciation of the yuan's real exchange rate**. China will try to counter Japan's weak-yen strategy because the two countries are no longer catering to different markets. It is not any more about labor-intensive mass products from China – plastic toys and jeans - versus sophisticated high-tech products from Japan. China has aggressively moved upmarket in recent years and will fight for market shares. I would not bet on a strong yuan.

Weak China, weak commodity markets

38. Commodity producing countries will suffer even more from China's malaise than the rich industrialized countries. The reduction of China's demand for fossil fuels and metals will exert strong downward pressure on their prices. Falling international freight rates are also part of the picture.

Brent

US$ per barrel



source: International Monetary Fund

metals prices*)

2005=100

*) includes copper, aluminum, iron ore, tin, nickel, zinc, lead, and uranium price indices (in dollar terms)

39. **For Russia in particular, with its reliance on fossil fuels and metals, export revenues in foreign currency terms have been plunging** (Jan through Apr: -29% y/y). Real GDP will fall by about 3½ percent this year compared to 2014. The shock has been cushioned by the huge depreciation of the rouble which has led to a significant reduction of imports (-38% y/y) – the surplus in the balance of trade has shrunk somewhat but remains very large. For consumers, real incomes have fallen at rates of 6 ½ to 7 ½% y/y as import prices have risen so much that headline inflation has shot up to 15.3% y/y. Nominal income growth simply could not keep up with the increase of inflation. Things will probably get worse before they get better because it is likely the sell-out in commodity markets will continue.

40. Other countries which will suffer a lot are South Africa, Canada, Nigeria, Venezuela or Indonesia. Thinly populated OPEC countries in the Gulf have less problems coping.

41. **The winners are the commodity importing countries.** They will benefit from the improvement of their so-called terms of trade. For each airplane or machine they export they get more oil or gas or steel than before. The purchasing power of the population rises – people can spend more without working more. It's one of the rare cases of a free lunch. It is also one of the rare cases where an economic stimulus program is underwritten by foreigners.

42. **The commodity crash has increased the probability that real GDP growth in the euro area will be higher than presently forecast.** According to today's IMF Update of the World Economic Outlook it will be just 1.5% y/y in 2015 – I think the actual outcome for the year will be somewhat better, depending on the further development of the oil price. The euro area responds much more positively than the US to changes in import prices.

43. In my last Investment Outlook I had made the case that **the value of companies that produce fossil fuels would fall as the world decarbonizes**. Recent developments in energy markets have made this argument even more convincing.

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