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Wermuth's
Investment Outlook

November 2015

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The trends to watch

by Dieter Wermuth[*]

1. To start on a positive note: in terms of real GDP at actual exchange rates**, the world economy will probably expand at a rate of 2½ percent in 2015. For next year, the IMF expects an acceleration to 3 percent.** Both numbers are close to the long-term (18-year) average of 2.7 percent. Since the world's population grows at a rate of only 1 percent a year, output and thus real income per capita are increasing by 1½ to 2 percent. According to the IMF, in emerging market and developing economies the output per capita will actually gain 2.8 to 3.7 percent in 2015 and 2016. Even if not everybody benefits equally, the fact that the pie keeps getting bigger is good news.

some home truths

2. From this bird's eye perspective there is **no reason for financial investors to despair – earnings are positively correlated with growth, as are asset prices**. The popular view that it is impossible to make money in today's capital markets is simply wrong. Globally, the economic situation continues to improve. Analysts like myself are often overly impressed by the many risks and the crises of the day, like the flood of refugees, the recent Greek crisis, the slowdown of the Chinese economy or the seemingly unstoppable slide of rich countries into deflation.

3. **But there is actually no evidence yet that the catching-up process of the poorer countries - which have been the main drivers of the world economy for more than a decade - is about to stop.** Remember 2009? What is regarded as the Great Recession in the OECD area had hardly touched the other part of the world; growth there had slowed from 5.8 in 2008 to 3.1 percent. It then bounced back to rates of 5 to 7 percent. Based on high saving and investment ratios, falling transportation costs and ever better information about international market trends and opportunities, the underlying growth momentum remains strong. Emerging and developing countries now account for more than one half of global output (on a purchasing power basis) and thus depend less and less on what is happening in North America, Japan and Europe.

[*] 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.

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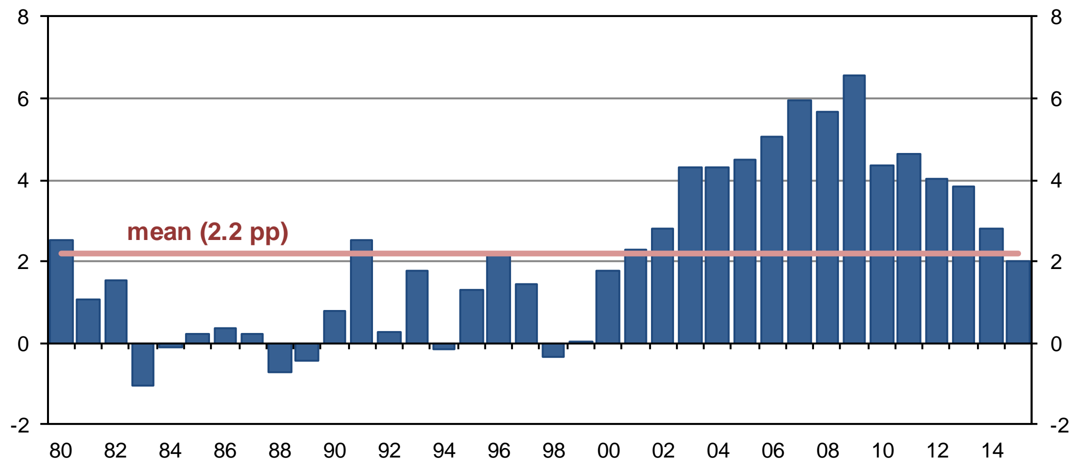


*) EME growth rates minus advanced economies growth rates; real GDP based on PPP; 2015 IMF projection

source: IMF

4. **Any portfolio with a focus on growth must therefore hold securities of companies which are either located in emerging markets or do business with them, such as exporters or direct investors.** Returns are on average higher than suggested by differentials in real GDP growth rates – this reflects the fact that risks are higher than in the mature markets of advanced economies. Think autocratic regimes, corruption, theft, non-transparency of accounts and ownership structure, or risks of capital controls and currency depreciation. Investors who do not want to, or are unable to get involved in these issues should stick to OECD-firms which operate successfully in those risky markets.

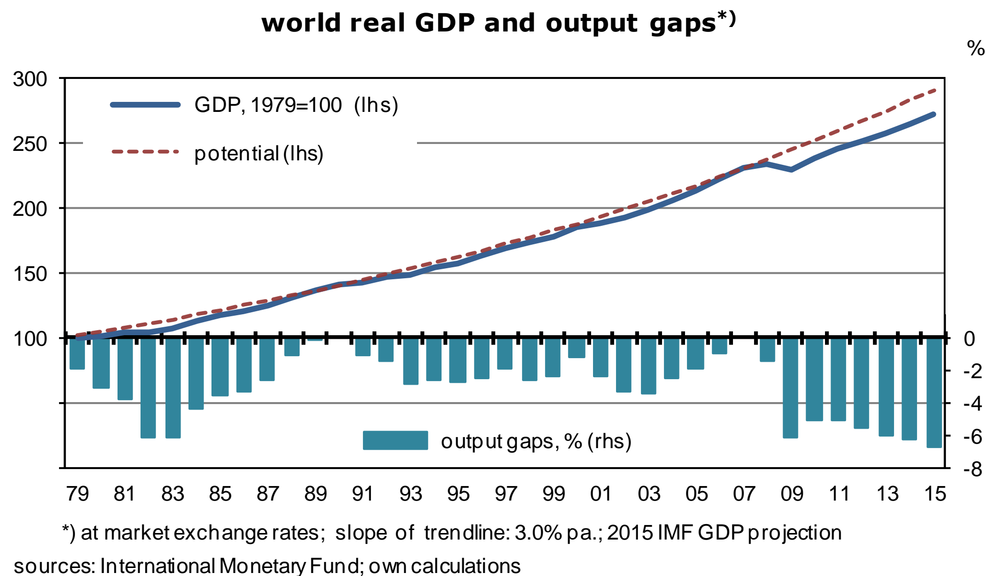
5. In spite of fairly anemic economic growth in the US, Japan and Western Europe there are plenty of firms in these regions which are worthwhile investment targets. **Structural change can be rapid even if overall growth is low.** Some industries shrink or disappear, others expand or are newly created. The market capitalization and valuations of utilities based on fossil fuel or atomic power, commodity producers, print media and auto companies with an emphasis on Diesel engines have recently declined considerably. Winners have been tech firms, health providers, pharmaceuticals, insurers, “green” firms and everyone who benefits from the new forms of communication.

6. **Financial investors should do well if they are able to identify – hopefully earlier than others – the main structural changes in the composition of world output and the effects of monetary and fiscal policies, exchange rates, regulation, innovation, capital flows and trade on relative prices and competitiveness.**

the mega-trends

7. One of the main trends that will shape capital markets is the **brisk catching-up process in most less developed countries** and their rapid integration into the world economy. Some momentum has been lost recently but the underlying forces are still in place. **Chinese growth remains high but is much slower than it used to be** – not all of the country’s massive savings have been spent wisely on profitable projects. Overinvestment has led to

significant declines in asset prices and thus to negative wealth effects on spending. Since the country is the most important buyer of **commodities, their prices will remain under pressure**, oil in particular. Those **emerging economies and firms are in trouble which rely on producing and exporting raw materials**, especially if they had bet on ever rising prices – unused capacities and foreign-currency debt are now haunting them.

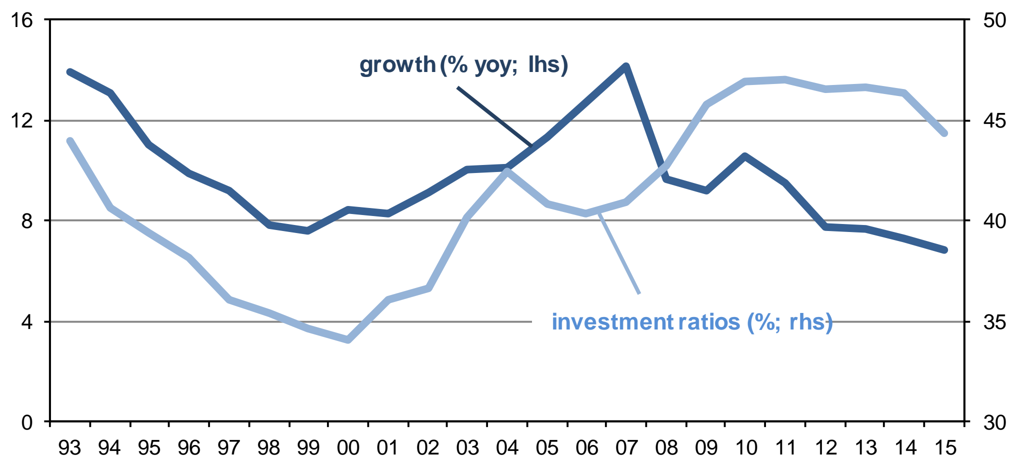


8. As to the **future of rich countries, most of them are still characterized by sub-par growth, large output gaps, unusually weak investment activity, stagnating productivity, not only disinflation but absolute price stability, bordering on deflation, and ongoing efforts by banks, governments and households to reduce their debt burdens ("deleveraging")**.

9. In the **euro area and Japan**, massive injections of central bank money into the banking sector will continue, combined with near-zero nominal policy rates. **In the US**, the Fed is about to tighten policies in response to robust labor markets, but will proceed very cautiously as headline inflation and inflation expectations remain subdued. Stock, bond and property markets in advanced economies are driven by easy money and have reached exaggerated valuations.

why China has slowed – and what this will do to the rest of us

10. If China sneezes these days, the rest of the world economy catches the cold. **Growth had long been driven by an extreme emphasis on capital spending.** The investment ratio has come down in recent years but, at 44.3 percent of GDP in 2015, is still very high compared to advanced economies; in the US and Germany the ratios are between 19 and 20 percent. The Chinese are a very frugal lot – they have been saving so much of their income that they had no problems funding their investment boom exclusively from domestic sources. A "normal" emerging economy is supposed to be a net importer of foreign capital. Not so China – the saving surplus was so large that the country was, and still is, a major net exporter of capital, reflected in correspondingly large surpluses in its balance on current account, the accumulation of the world's largest stock of currency reserves and (until one year ago) a strong exchange rate.



11. Just as trees won't grow to the sky, there are also natural limits to the rate of growth of economies. **A given amount of capital invested generates less and less of additional output the more has been invested already**. To keep up real GDP growth at the former rates of 10 percent or more thus requires an ever rising investment ratio, ie, a declining consumption ratio. Once the basic needs of the population have been met, once income and wealth have reached certain levels, it is not plausible to continue saving so much, though. People want to enjoy life when they can afford it, rather than toiling away, day in and day out. In other words, growth is bound to slow at some point.

12. China has clearly entered such a phase. Its **economy is still racing ahead, but at rates of 5 to 7 percent and not 10 percent anymore.** This deceleration has been enough to create surplus capacities which in turn have led to financial problems at state-owned enterprises, local communities and households who had based their borrowings on the assumption that earlier growth rates would be the new standard. According to commentators on Bloomberg, "Chinese borrowers are taking on record amounts of debt to repay interest on their existing obligations, raising the risk of defaults and adding pressure on policy makers to keep financing costs low." This is sometimes called a Ponzi scheme and could precipitate a financial crisis and a full-fledged recession.

13. **Financial investors are not sure what to think about Chinese assets.** The Shanghai Composite stock index has lost about 30 percent since June 2015, but shares are not yet cheap: their average price-to-earnings ratio is 19.0 while the price-to-book ratio is an optimistic 2.1. The implicit assumption is that the authorities will once again be able to raise the growth rate of the economy and bail out defaulting borrowers. The assumption may be too optimistic.

14. Interestingly, the 10-year government bond yield is only 3.1% which is 1.8 percentage points above consumer price inflation – 1.8% is China's so-called "real" long-term bond yield. It compares to a real GDP growth rate of 6 to 7 percent and is an indication that participants in the bond market expect growth to slow further. Sentiment indicators convey the same message.

15. **A hard landing in China can no longer be excluded**. The slowdown is already weighing down on trade partners, especially commodity exporters like Australia, Chile and Brazil, as well as all neighboring countries such as Taiwan, Korea, Japan and Malaysia. Even far-away Germany feels the effects. Chinese imports are shrinking this year.

16. **Another channel of transmission is via the profits of foreign firms which have invested in China.** Total direct investments from abroad are estimated to have reached $1.5tr – if returns to these assets slow, so would global profits. On the other hand, risks to the financial sector in the rest of the world are fairly limited, I guess, because China is self-contained and has not been borrowing much from foreign banks and capital markets.

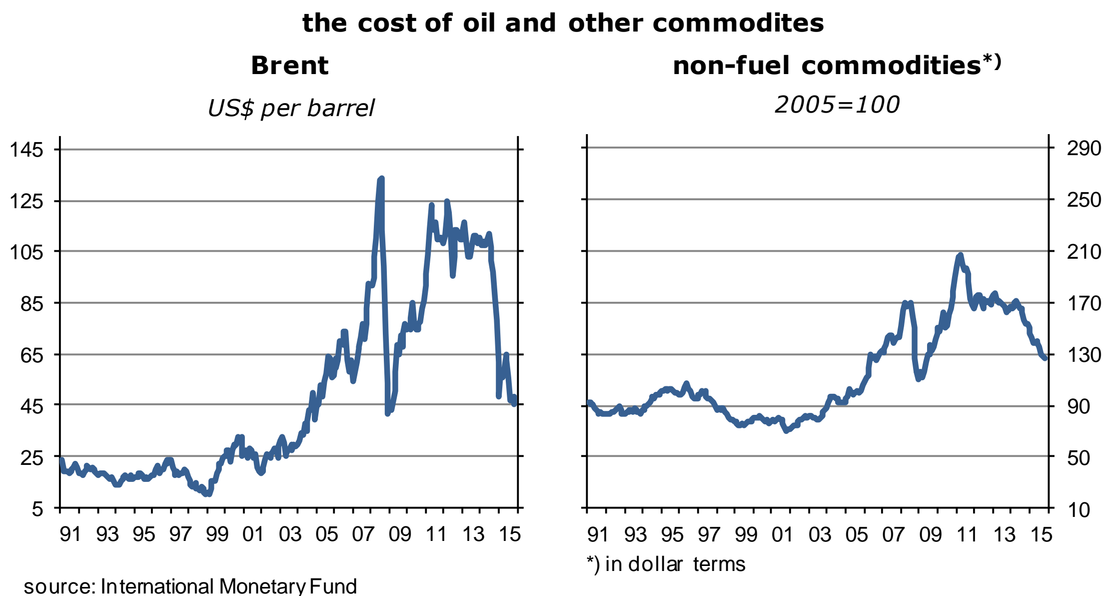
17. **To sum up, if a hard landing can be avoided China will remain the world economy's growth engine. Its catching-up process has many years to run** because per capita incomes are still only a quarter as high as in the US and the euro area, and there is no lack of domestically generated funds. But a return to those 20 heady boom years before 2011 is unlikely. There has been a major misallocation of resources which now weighs on growth. Excess capacities in heavy industry, infrastructure and housing reduce overall demand, including the demand for labor. In addition, the borrowing binge combined with slower income growth has left many households and firms overindebted which in turn forces them to deleverage, ie, to repair their balance sheets. As a result, they will increase their spending by less than usual.

commodity markets – China's main victims

18. This implies that **demand for commodities will not recover quickly**. China accounts for 11 percent of world oil demand and for 40 to 70 percent of the demand for other key commodities. That the rest of the world economy has also lost some momentum adds to the problems of raw material producers. On the **supply side**, high commodity prices and the general expectation that they had only one way to go – up! – had led to intensive exploration and the development of new mines and oil fields. In the US, the production of shale oil had become a viable business, in spite of high production costs.

19. **To cover overhead costs when demand began to weaken, output was raised rather than cut back.** This made sense from a micro point of view because the marginal costs are often very low – in an environment of falling output prices it is often better to produce than not to produce. In this way, falling prices become a self-fulfilling prophesy, though.

20. Commodity prices are under pressure from both sides – weaker demand and excess capacities. The question is when enough is enough. **What could bring about a trend reversal?** The price of crude oil has fallen by about 60 percent since the summer of 2014. Prices of aluminum, copper, nickel, zinc, steel or iron ore have plunged by similar percentages. Commodity professionals keep predicting trend reversals only to see prices drop even more. Many traders have lost their shirts and have been forced to cut their positions. Price recoveries are still mostly used to get out of the market. Traders are very skeptical these days.



21. The mood is so depressed that no one dares to go long anymore. Usually, this is a situation where bits of good news could trigger a strong rebound, reinforced by the widespread need to cover short positions. What sort of good news are presently the most likely ones? Lower interest rates, rising inflation expectations or upward revisions of economic growth forecasts for China and the rest of the world would help, but none of this is actually on the cards. **So I would put the highest probability to some sort of technical reaction, given that everybody seems to be short.** At some point these “shorts” will want to take profits - which could then finally turn around the herd (of “bears”).

22. Another, related aspect: it is surprising that **the flood of liquidity created by central banks has boosted the prices of stocks, bonds and property but not those of the other important real asset class – commodities.** Why is this? Raw materials had probably been totally overpriced in reaction to panicky pre-recession forecasts that the world was about to run out of them; they may have recently been on the road to more realistic, ie, lower valuations. Still, I guess that they will be rediscovered at some point soon. Most of them are cheap. **In a “mean reversal”, a price rebound by 30 to 40 percent is entirely feasible.**

23. **Longer term, though, commodities are not attractive for investors**, except, perhaps, in case India follows China one day and goes for all-out industrialization as well. If not, prices will remain under downward pressure as the structure of global growth continues to shift toward services – and these are less commodity intensive than manufactured goods. Another factor that keeps prices down are the ongoing **advances in resource efficiency and efforts to create a circular economy** where the metal components of discarded manufactured goods are recovered and recycled. The remaining waste is increasingly used as an input in electricity production (which reduces the need for traditional fossil fuels).

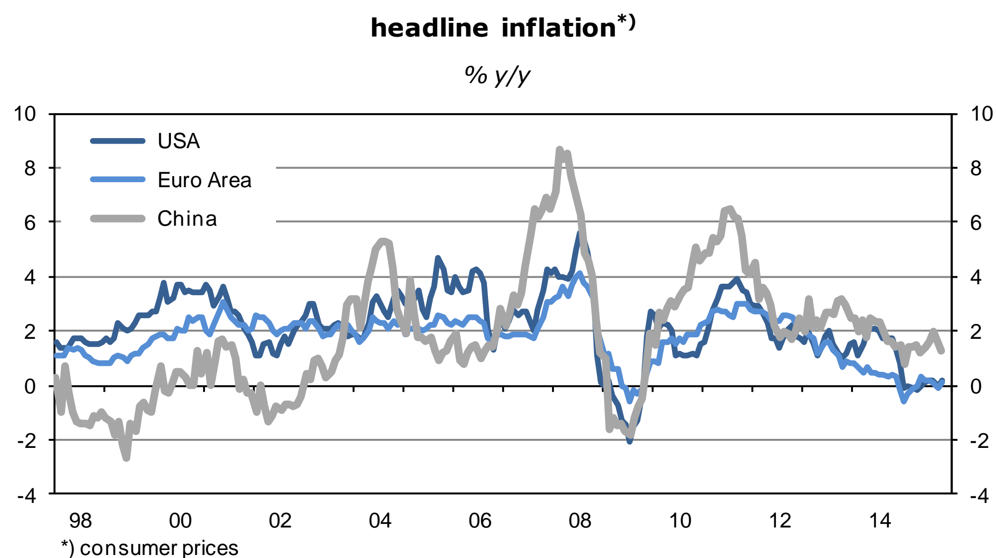
24. In the meantime, **commodity producing and exporting countries such as Russia, Australia, Brazil, Venezuela and South Africa are struggling**. Their export revenues have declined by up to one half in a very short time which in turn has led to cutbacks on imports from countries which produce manufactured goods. Via the trade channel this has direct negative effects on the economies of the euro area and the OECD area in general.

25. A second, potentially more **dangerous channel of transmission from the commodity producers to the rest of the world is via the banking system and capital markets**. As always in good times, the miners and oil people step up their foreign currency borrowings to finance their investments – interest rates on this kind of debt are usually much lower than on their domestic markets. And "western" banks and bond investors are more than eager to provide the funds; for them, in a world of low interest rates the attraction is the relatively high yields they can get from this sort of lending. Right now, supposedly safe loans and bonds turn into non-performing assets and hit the balance sheets of the lenders. The verdict is still out on how serious this is for the financial sector of the rich countries. Another global financial crisis in the making before the previous one has been overcome?

disinflation and deflation will not go away soon

26. How about global deflation? Is the trend of stagnating and falling price levels about to end? I don't think so. **It is a fairly safe bet that the next few years will be inflation-free.**

27. There are **two types of deflation**, a good one and a bad one. **The good one is** caused by technical progress, productivity gains, an intensified division of labor, economies of scale, falling transportation costs and better terms of trade. It's **a supply side phenomenon** and has been a characteristic of the 19th century industrial revolution: while price levels declined, wages and profits rose, as did real incomes. There are elements of this in post-1990 Japan. An oil price crash is also usually of the benign sort: real household incomes rise while wages and profits hold steady. Raising policy rates in this sort of deflation environment would not be negative for economic activity.



source: OECD, ECB

28. **Bad deflation has to do with weak demand, large spare capacities and underemployment.** Because competition is intense in such an environment, firms cannot afford to hike output prices, while workers have problems getting higher wages. When a credit-driven financial bubble goes bust, deleveraging sets in, ie, widespread debt reduction in an attempt to restore creditworthiness. Monetary policy loses traction because it is very hard to stimulate

borrowing via low interest rates and easy credit conditions if important economic agents are focusing on doing just the opposite: on reducing their borrowing.

29. **The euro area is in the grip of the latter sort of deflation, with unemployment still near 11 percent and low capacity utilization rates. The US, on the other hand, has been approaching full employment** if not a high rate of capacity utilization; average productivity growth of 0.5 percent over the past five years is also disappointing, as is the depressed labor force participation rate. But overall, US demand is fairly strong, with real GDP growth of 2½ percent this year and next, about one percentage point more than that of the euro area. That average consumer price inflation in 2015 is exactly the same as in Europe (0.1%) is therefore not because of weak demand but a result of the strong dollar and the decline of import prices by more than 10 percent (y/y).

30. **In the US, there are clearly stronger elements of good deflation than in the euro area which is why the Federal Open Market Committee can afford to consider a first rate increase next month (Dec. 16) whereas the ECB wouldn't dare to.**

bond markets are well-supported

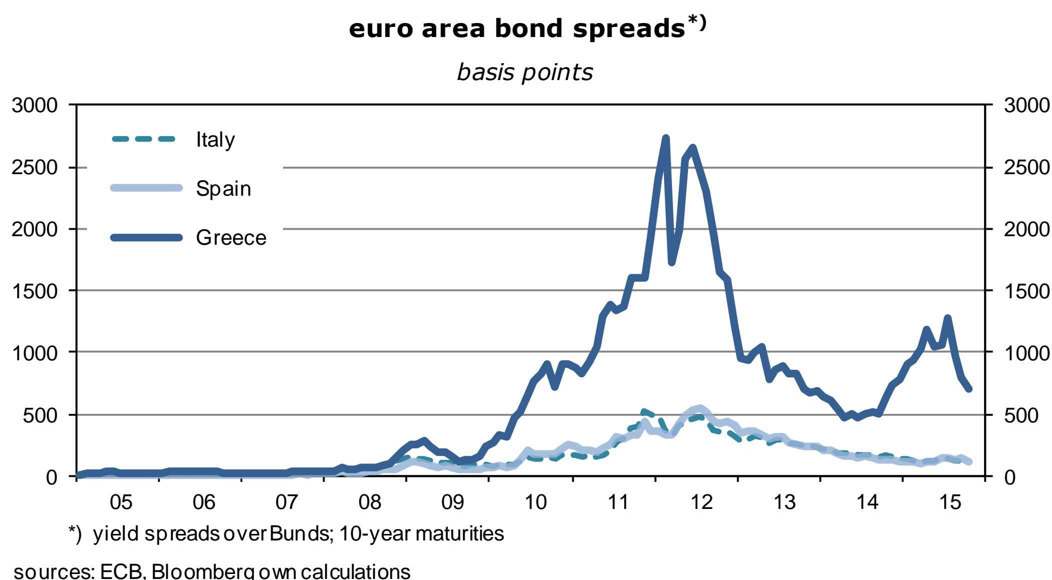
31. **In Europe, investors can bank on negative to zero policy rates** for at least one more year. While government bond yields in AAA-rated markets are already very low there is little risk that they will rise significantly in the foreseeable future. Incidentally, since the euro area has a relatively open economy, there are also supply side effects from international trade – they add to the deflationary effects of weak demand.

32. Over time, **permanently low oil and other commodity prices tend to reduce inflation expectations** which not only leads to falling long-term interest rates but also to lower wage inflation. One effect reinforces the other. This mechanism explains the stickiness of the euro area's near-zero consumer price inflation and the deflation of producer prices. If one day the euro exchange rate bounces back again, deflationary effects will become even stronger than they are today.

33. **That longer-lasting deflation is a more likely than in the US explains the large gap in bond yields. Today, 10-year US Treasuries yield 2.22%, compared to 0.50% on Germany's Bunds.** The difference can also be interpreted as reflecting the expectation that the euro will appreciate. Its exchange rate against the dollar is very volatile – since its inception in January 1999 it has fluctuated wildly between $0.84 (in 2000) and $1.60 (in 2008). If, based on its sound fundamentals and policy makers' moves to strengthen the currency's institutional set-up, it moves back to its old highs, the euro area would be in for an additional deflation shock. The ECB is quite scared of such a scenario.

34. For some time at least, **yield spreads between the various euro area markets are bound to shrink further.** Governments in previous crisis countries have more or less been doing their homework. Ireland and Spain in particular stand out and have returned to buoyant growth. The main fixed income strategy consists of buying Greek, Spanish and Italian bonds and selling German and Dutch bonds.

35. As to **Germany's benchmark bonds**, the yield spread between 10 and 2 years is 89 basis points (+0.50 and -0.39) today. Given the persistent deflation outlook and the likely response of the ECB I expect the "yield" at the short end to decline further (in Switzerland, 2 years have arrived at -1.01%) while the long end cannot fall much more – it is partly driven by the much higher US Treasury yield. The US yield curve will probably flatten: short rates up, long rates up by less (or even down, with market participants impressed by the Fed's tightening).

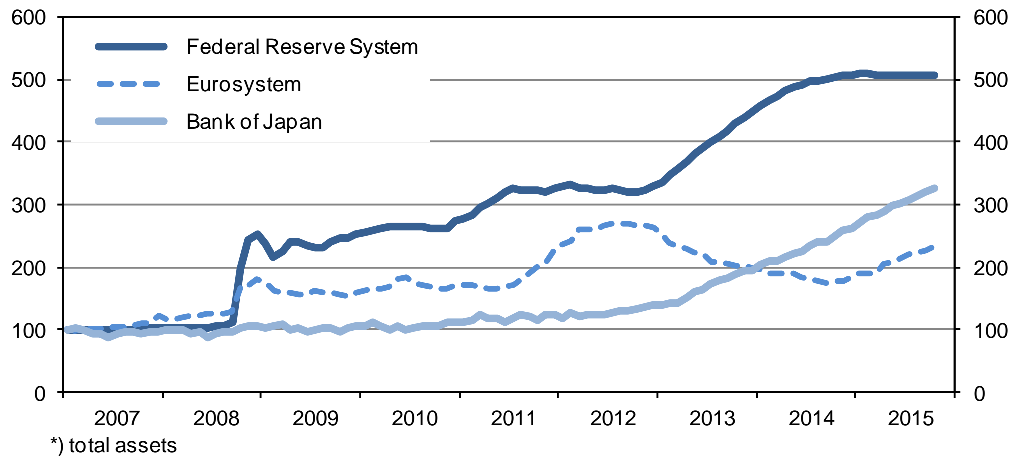


stock markets follow fixed income markets

36. Very expansionary monetary policies and declining inflation expectations in all of the world's major economies have not only led to record low rates on fixed-income markets but also to buoyant stock markets: **bonds and stocks are to some degree regarded as substitutes**. Since I am optimistic about bonds I am also optimistic about stocks. I have to be. The question is whether they have lost touch with their own not-so-stellar fundamentals by now and whether and when we are in for a rude awakening. I have frequently argued that stocks are no longer cheap but I have to admit that this statement was made very much without the bond market in mind.

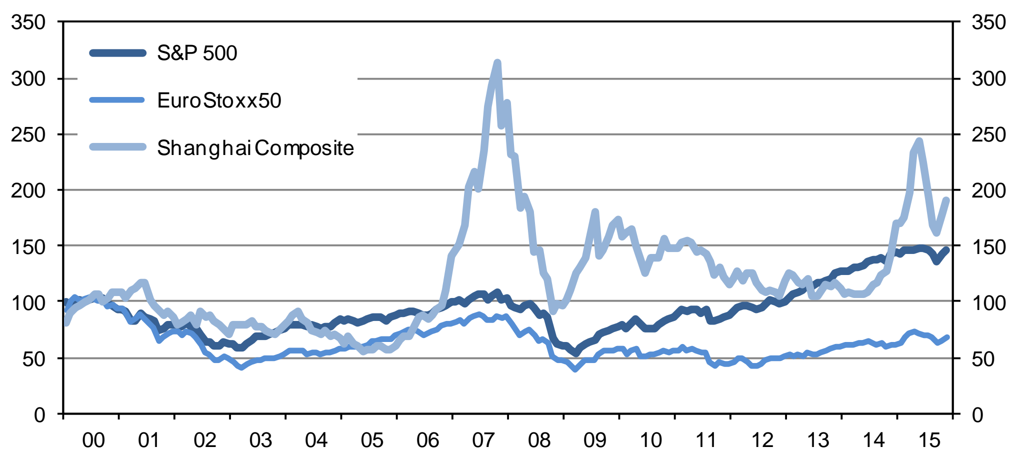
37. At this point, I would still argue that **stocks are expensive. But a crash is not imminent**. This is mostly because the ECB, the Bank of Japan and the People's Bank of China have pulled all stops in an attempt to avert deflation and get inflation back to target. Since they cannot be sure of success they are forced to keep the foot on the accelerator.

38. At the same time, **the Fed will probably proceed only cautiously as long as there are no signs of a new inflation mentality** or, more precisely, of a wage-price spiral. Incoming data have to be monitored closely in this regard. It is somewhat disquieting that US average hourly earnings have suddenly shot up to an annual rate of 2.5 percent in October, after they had fluctuated in a narrow range of 2.0 to 2.2 percent for more than four years. Could be that American workers have finally gained new negotiating powers – employment is up 2 percent from one year ago, and the unemployment rate has fallen to 5.0 percent.



39. For a long time, analysts had wondered why wage growth had been so subdued. It is not my main assumption, but it could just be that the day of reckoning is near. If the Fed reacts more forcefully than markets expect today, US stock markets might well crash.

40. American price-to-earnings ratios based on the latest available earnings numbers average 18.7 – since profits are barely rising this year, not least because of the strong dollar, p/e ratios in terms of expected earnings are not much lower. In other words, **American stocks are quite expensive.** This assessment is confirmed by the rather rich price-to-book ratio of 2.82 (S&P 500) and the risk premium of only 3.1pp (the difference between the earnings yield of 1/18.7 = 5.3% and the risk-free real long-term rate of 2.2%). A normal premium of about 5 pp would definitely be a more comforting safety cushion. It would not take much, it seems, to push US stock markets over the cliff.



41. **Things are more reassuring on the European side of the Atlantic.** At first glance, p/e ratios based on published company results of 22.35 for the EuroStoxx 50 and 23.40 for Germany's

DAX index suggest lofty valuations. Since corporate earnings can be expected to increase strongly in the coming quarters, current year p/e estimates are considerably lower than these numbers: 14.75 for the EuroStoxx, and 13.38 for DAX companies. They translate into risk premia of no less than 6.3 and 7.0 pp, respectively.

42. **The devaluation of the euro against dollar, yen, pound sterling and Swiss franc has turned euro area stocks into attractive assets; firms have become very competitive.** The price-to-book ratios of 1.56 and 1.73 for EuroStoxx and DAX confirm this statement, just as their dividend yields of 3.5% and 2.7% - on average, S&P 500 stocks offer only 2.1%. In addition, investors must not be afraid that the ECB will start tightening. Sub-target inflation and anemic economic growth force the bank to pursue very easy policies for the foreseeable future. Mr Draghi is quite openly interested in a weak exchange rate of the euro – if it is impossible to raise inflation rates domestically, importing inflation from abroad is a plausible alternative.

43. The question is **what a major stock price correction in the US will do to European markets**. It is certainly not helpful, but the modest valuations are like an insurance policy – they will soften the blow. The main risk in such a case is that the euro might appreciate too much and too quickly, as investors in US assets run for the exits. On the other hand, a strengthening euro would be a signal for the ECB to extend its easy policies. It would drive long-term bond yields even closer to, perhaps even below the zero line, and thus stabilize euro area stock markets.

44. **Finally, a word about the Japanese stock market**. In spite of the 50-percent appreciation of the dollar against the yen in the last couple of years, corporate earnings of Nikkei 225-firms are rising only slowly. The main reason has been the loss of growth momentum in China, the country's largest trading partner. Moreover, by at least two yardsticks, Japanese stocks are not really cheap: the price-to-earnings ratio on the basis of expected profits is 19.2, and the dividend yield is a low 1.6%. On the other hand, I have calculated that the risk premium is a healthy 4.9 pp; the price-to-book ratio is also reasonable: 1.8.

45. **To sum up, based on valuations and likely changes of monetary policies, US stocks are most at risk. While it is normal that European stocks trade at discounts to their American counterparts, they are particularly cheap at this point, both in absolute and relative terms. Japan is somewhere in-between, both cheap and expensive, and most of all very dependent on China's uncertain dynamics.**

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