



Wermuth's Investment Outlook

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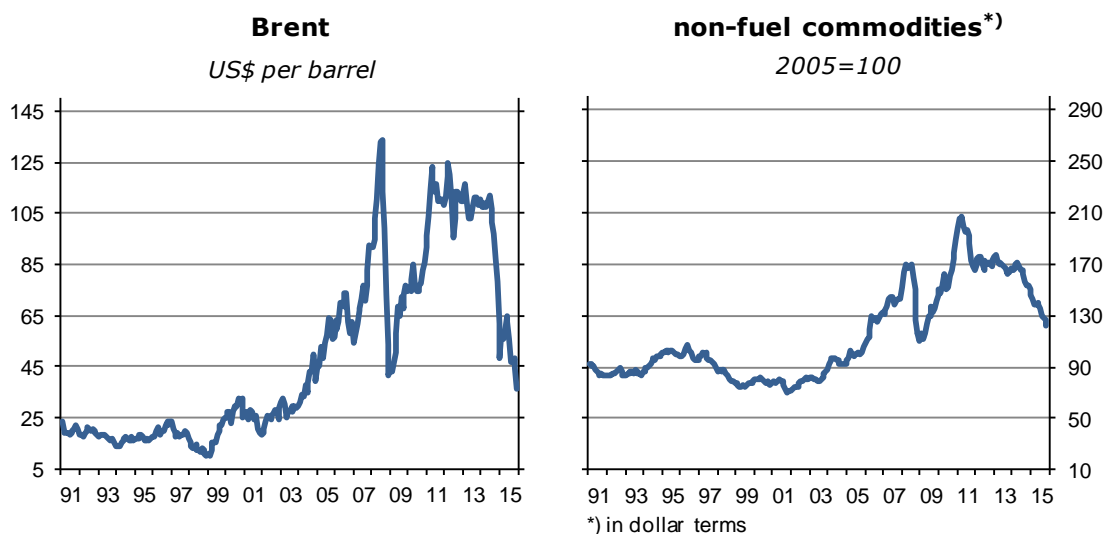
January 7, 2016

Global economy slows, deflation risks on the rise again

by Dieter Wermuth*

1. **Consensus forecasts for global economic growth are probably too optimistic.** In terms of purchasing power parities rather than actual exchange rates, the world's real GDP will expand by 3.3 percent year-on-year in 2016, after 2.9 percent in 2015 – says the OECD in its latest Economic Outlook. At the same time, the output gap is supposed to shrink, the average unemployment rate will fall from 6.8 to 6.5 percent, and inflation will accelerate to 1.5 percent, after falling to 0.8 percent last year.
2. **These are near-perfect developments – if the actual results come close to those forecasts. Financial investors who prefer equities over bonds would be vindicated.** Today's valuations of stocks may seem high, but the combination of robust global output growth, subdued inflation and the likely continuation of easy monetary policies suggests that they would soon look reasonable. In addition, if the OECD scenario does indeed materialize, investors cannot do much wrong to return to commodity markets; after last year's crash, prices would probably stage a strong rebound.

oil and other commodity prices



source: International Monetary Fund

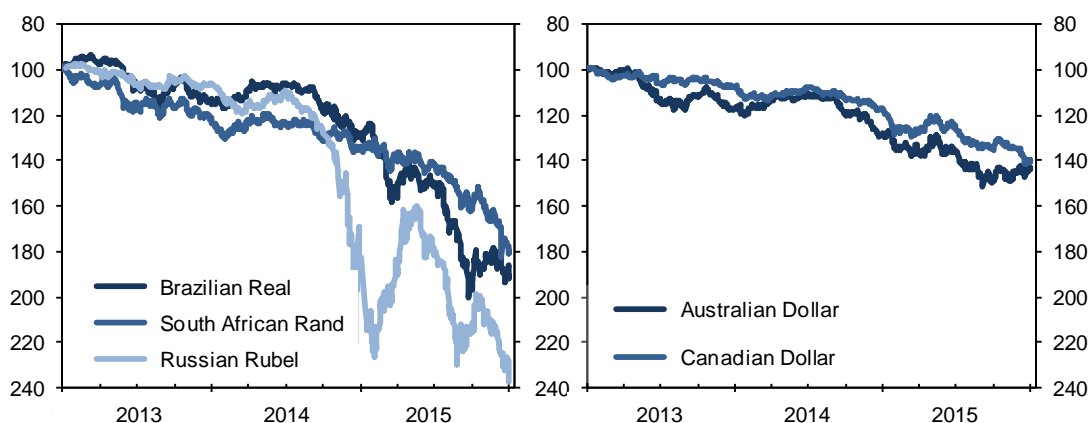
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China's slowdown hits commodity markets

3. **So why do I have my doubts? There are simply too many indicators that point in the other direction: growth will be slower than expected, and inflation refuses to accelerate; global disinflation continues. The main recent drivers of global growth – emerging markets in catching-up mode – have rapidly lost momentum.** The commodity exporters among them have been hit by a real income shock caused by a big decline of their terms of trade while China, the world's main importer of raw materials, could not fully benefit from a correspondingly positive terms of trade effect. The fall-out from a long period of overinvestment plus the attempted strategic switch from manufacturing, housing, infrastructure and exports to services and private consumption have led to a reduction of real GDP growth from an annual average of 10.5 percent in the ten years to 2012 to 6.6 percent year-on-year in the fourth quarter of 2015. As it is, usually trustworthy analysts consider today's true growth rate of China to be actually two to three percentage points lower than that. The five-year low of the yuan against the dollar could be another sign that the economy is not doing well – the weakness of the exchange rate is in spite of a likely annual current account surplus of almost \$300 bn.
4. **The list of commodity exporters which have fallen on hard times is quite long.** It contains emerging heavyweights such as Brazil, Russia, South Africa, Nigeria, Indonesia, Saudi Arabia, Iran, the other Gulf countries, but also some rich countries: Canada, Australia and Norway. Even the US and its once-vibrant shale oil industry have been hit by the implosion of the oil market. A large portion of the world economy is deteriorating as commodity prices continue their slide.

exchange rates of commodity producing countries*)

Dec. 2012 = 100



*) national currency per one US dollar

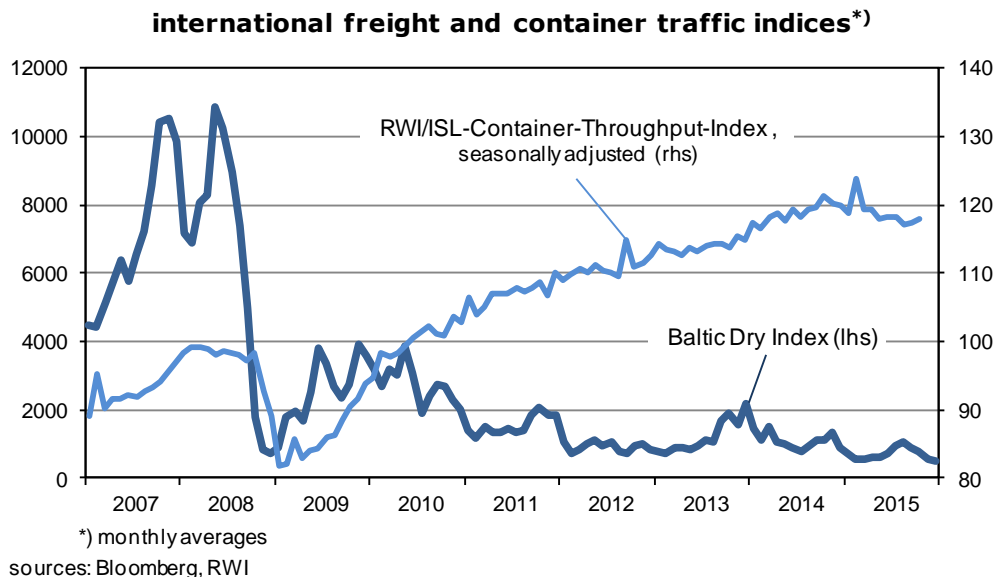
sources: Federal Reserve; Bank of Russia

world trade has lost momentum

5. Catherine Mann, the chief economist of the OECD, has pointed out in the editorial of the organization's last Economic Outlook that **the volume of world trade has recently either stagnated or declined. In the past, low or negative trade growth used to be accompanied by a global recession.** In other words, the world economy might be in, or be close to a recession if data do indeed suggest that international trade is not expanding anymore.



6. Except for 2009, there has never been a recession in the sense that the world's real GDP has fallen below its year-ago value, but a growth rate of just 2 percent or less, as suggested by stagnating cross-border trade, is so far below the trend rate of 3 ½ to 4 percent that it certainly feels like a recession. The output gap, the difference between potential and actual production, is widening these days. **If the business cycle is divided into just two phases, expansion and recession, the world economy has probably already entered a recession if trade statistics are once again a reliable predictor.**



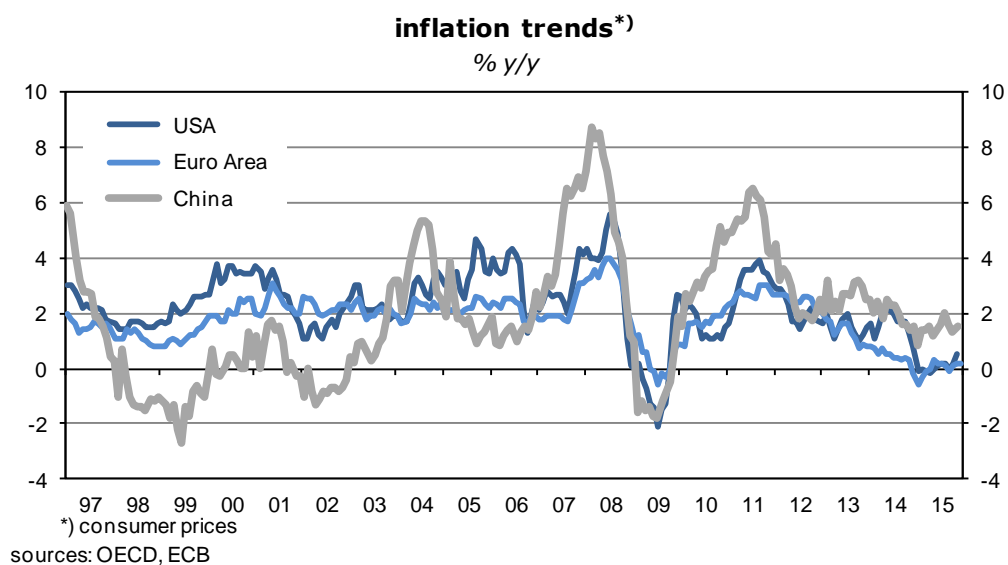
7. **Evidence that international trade is no longer expanding at the brisk rates of the past** is provided by recent freight rates of ocean-going ships. Both the **Baltic Dry Index** and the **Harpex index** which cover bulk carriers and container ships, respectively, have been in steep decline since last summer and are now below or close to historical lows. Part of this decline may reflect an oversupply of shipping capacities, but since these do not change much in the near-term the main determinant must be weak demand for internationally traded goods. Alternatively, according to the **global RWI/ISL index for the container traffic** at 81 ports,

throughput last September and October was on average 2.4 percent lower than one year ago – a long trend of ever expanding container shipments has come to a temporary end.

8. Another indicator which supports the view that world trade is either **stagnating or shrinking** is the **decline of export and import prices**: the OECD estimates in its Outlook (page 24) that both in the OECD area and in the rest of the world they have come down by 7 ½ to 13 ½ percent in 2015 compared to 2014. If world trade had been strong, prices would not have fallen so much.

global inflation remains subdued

9. All this means that global inflation is unlikely to start rising just yet. When output gaps widen, as seems to be the case at the moment, it is difficult for workers to achieve appreciable wage increases while firms are typically unable to raise output prices by much. Predictably, **inflation statistics continue to surprise on the downside**. Here are the most recent headline consumer price inflation rates for the four largest economies – the numbers of one year ago are in parentheses: China 1.5 (1.4), US 0.5 (1.3), euro area 0.2 (-0.2), Japan 0.3 (2.4). According to the OECD (p. 14), “market-based measures of inflation expectations have edged down further.”



10. **Inflation-linked government bonds** show that over the next ten years investors expect inflation to average just 1.6 percent in the US, 1.0 percent in France, 0.9 percent in Germany, 0.8 percent in Italy and 0.7 percent in Japan. Over the 5-year term, expectations are even lower: investors do not believe that central banks will reach their 2 percent targets.
11. The most **worrying development takes place in China**: when its real GDP expands at a rate of, say, 6 percent, while employment increases by 0.4 percent (IMF numbers), productivity and consumer prices should be up by at least 5 percent. But it's not happening. It is a sign that there are lots of idle capacities in the economy.
12. Central bankers like to point out that falling inflation rates mostly reflect falling commodity prices, oil prices in particular. So-called core consumer price inflation which excludes energy (and sometimes seasonal food) from the index is indeed higher, if only somewhat, than

headline inflation, with the notable exception of China (where it is identical). The idea is that core inflation reflects underlying and expected inflation – over time, headline inflation fluctuates around it. But **even the core rates do not suggest that prices will rise at a faster clip this year. Disinflation continues.**

oil prices may not have bottomed out yet

13. I would also not exclude the possibility that oil prices will fall some more. All forecasts I have seen recently are based on the assumption that they will rise from here on. This is probably wishful thinking. Remember your introductory course in microeconomics? **If there is perfect competition, the price of any good will be determined by the cost of producing the last unit** – in the case of oil, it would be the cost of lifting the 93rd millionth daily barrel from the ground. Given the huge reserves of the Gulf region and the easy access to them, it is a safe bet that the marginal cost of oil production is well below \$15. Unless there are supply disruptions caused by a military conflict, or unless the OPEC cartel agrees on a common strategy again, today's 31.5 dollars for a barrel of Brent must not be the lower turning point. In other words, oil prices have room to fall further and may thus exert additional downward pressure on consumer prices globally.
14. **For the environment this is bad news.** In relative terms, energy from sun and wind has been getting more expensive as oil prices have crashed. Prices of hydrocarbons are so low that burning them in power stations or in cars is quite attractive again, and it is not so urgent any more to switch to alternative sources of energy. The transition period to clean consumption and production will be longer than expected, and the incidence of climate catastrophes will increase.
15. **Only a policy of stabilizing (or raising) the (relative) prices of fossil fuels paid by end-consumers can stop a further rapid increase of the world's temperature.** I do not see this yet. So far, the nice declarations at the Paris climate conference have not been followed by action. Auto manufacturers and others who rely on cheap oil have gotten a new lease of life. Put more positively, the inevitable structural change will last longer and cause less frictions.

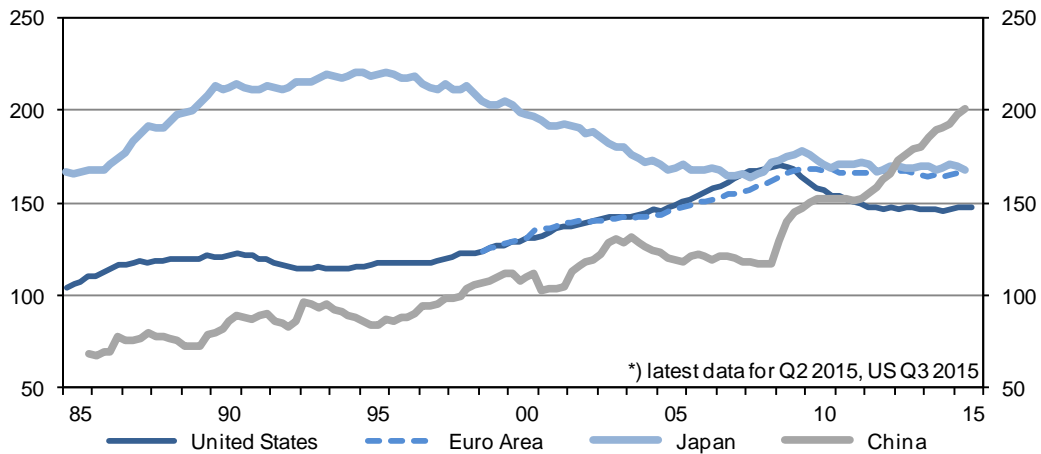
deleveraging – the never-ending story

16. Another factor that continues to slow down economic growth in the main economies is the unfinished business of debt deleveraging. The debt run-up in the years to 2007 - in response to the significant reduction of real policy rates - is still weighing on the financial situation of households and many banks: when the real estate bubbles burst, the value of the assets was suddenly less than the liabilities that had been incurred to buy those assets. Failing banks had in turn forced governments to launch extremely costly rescue operations which drove up public sector debt beyond sustainable levels.
17. **Households, banks and governments are still in the process of reducing their debt** – the US is probably most advanced in this respect while Japan remains in deleveraging mode, more than 20 years after the country's own real estate and stock market bubbles had popped.

central banks have run out of ammunition

private non-financial sector debt^{*)}

% of nominal GDP

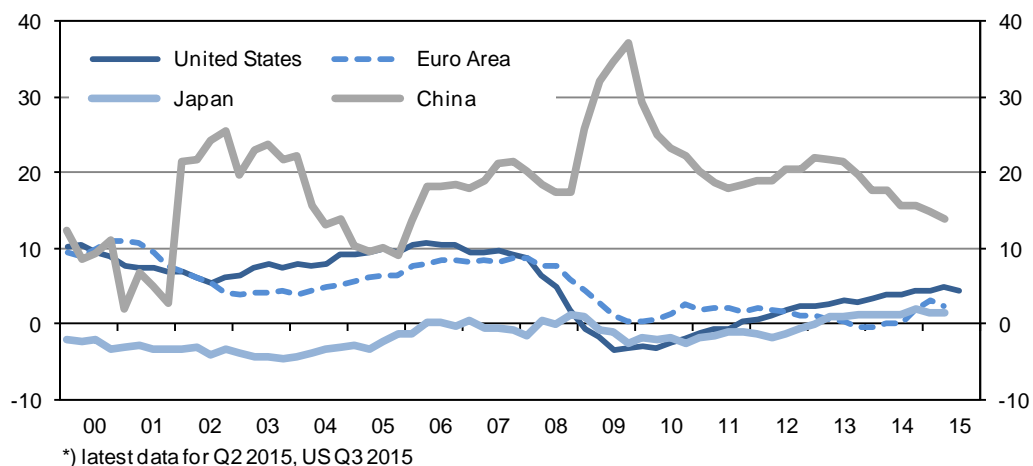


sources: BIS, Federal Reserve, own calculations

18. **Monetary policies are not efficient in such an environment.** In spite of the aggressive money printing of recent years, and policy rates at or near zero, lending is still subdued. Potential borrowers prefer to repay their debts rather than to pile some new debt on the old ones. Spending on goods and services will remain listless as long as deleveraging plays such an important role.
19. The best central banks can hope for is to prevent a downward spiral of debt reduction, weak consumption and investment, recessions and deflation. But they are not addressing the core of the problem: unsustainable debt. Some variant of **helicopter money could be a solution.** Free cash for everybody, without using banks as middlemen, until economic activity and inflation pick up again! We are not yet at a point where such proposals are given serious thoughts – but we may get there unless the broken monetary transmission mechanism can somehow be repaired by some other means.

loans to private non-financial sector^{*)}

% y/y, national currencies



sources: BIS, Federal Reserve, own calculations

20. Subdued inflation, combined with the prospect of a global recession, means that **central banks will keep their foot on the accelerator. They implicitly accept that near-zero policy rates and swamping the banks with central bank money dangerously distorts the distribution of wealth and income, the returns from real assets, and the balance between savers and borrowers.**
21. While the owners of stocks and bonds get richer as their prices are driven up by ample liquidity, holders of bank accounts and life insurance policies are faced with negative real interest rates and thus a loss of wealth. **The incentive to invest in plant and equipment, or housing, is small when financial assets can be expected to outperform those real assets.** Capital expenditures also continue to suffer in response to widening output gaps and weak final demand by households and business. Moreover, deleveraging has not yet run its course in some large economies. It had not even begun in China by the second quarter of last year which is another indicator for the problems the country is presently facing. In relative terms, the country's private sector debt is much higher than it ever was in the US, the euro area and Japan. It looks like a time bomb.
22. **In countries such as Germany, the corporate sector has morphed from the economy's main borrower to a net supplier of savings. Easy money thus contributes to the growth slowdown of potential GDP and thus comes at the expense of our children and grandchildren.** Governments are increasingly the main domestic borrowers, even though most of them are trying hard to reduce their debt. To some extent, low interest rates are doing the job for them. Since the demand for safe haven financial assets is so strong, yields have fallen to extremely low levels, both in real and nominal terms.
23. On the other hand, while indebted governments may enjoy the present low-interest rate environment, it **has become very tough for young savers to build a portfolio of financial assets which generates a decent cash flow for retirement.** Small returns mean they must probably set aside more money than they had originally planned. They must therefore adjust their spending habits accordingly. Bad news for the demand side of the economy!

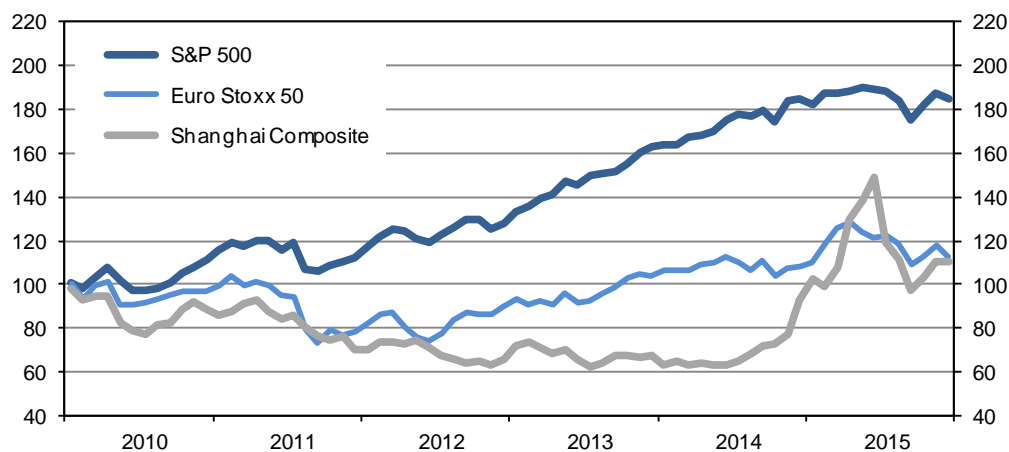
owners of stocks: beware of the global recession

24. The question is now whether the risk of a global recession has already been priced into stocks. Probably not, **because it has only been in the last few days that investors have begun to focus on the negative drivers of the world economy,** in particular the bubbles and imbalances in China, the effects of that country's slowdown on Asian neighbors, the crash of oil and other commodity prices, disappointing trade and GDP prospects, and the failure of inflation to re-accelerate.
25. **Even after the large corrections this week, valuations are still quite rich.** In the US and Switzerland they have been driven by safe-haven flows, reflected in strongly appreciating currencies; based on current-year earnings per share estimates, price-to-earnings ratios are 16.0 and 15.6, respectively, while price-to-book ratios are no less than 2.7 and 2.5. Investors have been extremely impressed by the two markets, perhaps too much. After all, the international price competitiveness has suffered a lot while the earnings received from companies' foreign subsidiaries are translated into dollars and francs at unfavorable exchange rates.

26. **On the other hand, American and Swiss risk premia are high by historical standards because the real yield of government bonds (which are used as benchmarks) is so low.** Compared to riskless assets, stocks look attractive on the basis of consensus earnings forecasts. I would suggest, though, that those forecasts are too high because they do not take into account the coming global recession. It will probably pay to wait for even lower stock prices once the current market corrections have run their course.
27. **As always, euro area stocks look relatively cheap.** Those in the EuroStoxx 50 have a p/e ratio of 12.9, those in Germany's DAX one of 12.1; Spain is at 13.0, France at 13.5, Italy at 13.7. Investors do not like those markets, it seems. Compared to the US and Switzerland, price-to-book ratios are quite low; they are in a range of only 1.0 (Italy) and 1.6 (Germany). This means that investors are neither willing to pay a high premium for the average European business model nor for the safe-haven qualities of the stocks. Euroland is not considered to be on par with well-established nation states such as the US and Switzerland.

major stock markets*)

Dec. 2009 = 100



*) national currencies; monthly averages

sources: Federal Reserve, ECB, own calculations

28. **This is the opposite of what the bond markets are telling us: the top issuers of the euro area can sell their 10-year bonds at yields of 0.53% (Germany), 0.69% (EFSF), 0.72 (Holland) and 0.91 (France) while the US Treasury has to pay 2.17%.** There are obviously still people who do not like America's relatively large current account and budget deficits. Incidentally, 10-year Swiss bonds yield a negative 0.12%: the current account surplus of the country is even larger than Germany's (relative to GDP), and the government is running a small surplus.
29. **Euro area stocks will continue to be supported by very low funding costs for at least another year.** Policy makers at the ECB are determined to do whatever it takes to bring back inflation. Quantitative easing will be expanded and penalty interest rates raised as long as there is no convincing evidence that this is about to happen. Some ECB watchers fear that the "just-below-2-percent" inflation target will never be reached as long as so many potential borrowers give priority to deleveraging strategies – as Japan has shown, it can take decades. So there is some talk now to give up the inflation target altogether, just as the money supply target of old had been quietly buried before. This could actually happen before the ECB takes the big step and starts to distribute free cash to all, including babies,

grandmothers, refugees and unemployed. A lot of water will flow down the Rhine before we reach that stage. It is nothing investors should worry about for the foreseeable future.

the hour of the contrarians

30. Contrarians may also point out that **euro area stocks are attractive in terms of valuations**, and that it is usually better to buy cheap rather than expensive stocks. The large depreciation of the euro will certainly be good for business and profits while real incomes of the European households have been boosted by the steep decline of import prices. Consumer spending is picking up briskly as a result. It helps that euroland employment expands at an annual rate of almost 1 percent and that fiscal policies are about to become less restrictive, if not outright expansionary. Europe is no longer the sick man of the world economy, and the euro is here to stay.
31. Mounting evidence that emerging markets are about to push the world economy into recession should be taken serious. Since investors do not buy this view yet, it will probably take time before stock markets in the rich countries reach their lower turning point. So there is **no need to hurry**.
32. **How about Asia**, until recently the growth engine of the world economy? It is almost self-evident that Chinese stocks are high-risk assets at this point. But Japan could be an alternative: the yen has depreciated from 78 per dollar in the fall of 2012 to 118 today. It has also weakened, if not so much, against the Chinese yuan. Price competitiveness is excellent and compensates for the weakening of demand from China and other countries of the region. At a price-to-earnings ratio of 17.1, stocks do not look cheap at first glance – but the risk premium is an impressive 5.9 percentage points, and the price-to-book ratio is as low as Germany's: 1.6. The financial sector of the country may still not yet be out of the doldrums, but manufacturing remains world class and is well prepared for challenges of the electronic age. Japanese stocks are fairly safe bets and good diversifiers.
33. **As to foreign exchange, there is sort of an undercover war going on**. The ECB quite openly favors a weak euro, the Chinese yuan is fixed at a lower rate against the dollar day after day, the Swiss do not allow a further appreciation of the franc – tourists are staying away! -, and Sweden has indicated that it will intervene should the krona approach 9 to the euro. Weak exchange rates are a means to boost competitiveness and employment but also inflation. I wonder how this is going to end. Most forecasts suggest that the dollar will soon reach parity with the euro – US policy rates will rise further while the ECB intends to ease. Fundamentals, on the other hand, argue for a stronger euro. To some extent, this also applies to the yen and the yuan.
34. In this uncertain and highly volatile environment **investors have almost no alternative but to diversify their assets across currencies**. This is easier said than done, I guess. If GDP weights are used as benchmarks, would one really allocate 20 percent to China – and how can this be done in practice?

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