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Wermuth's
Investment Outlook

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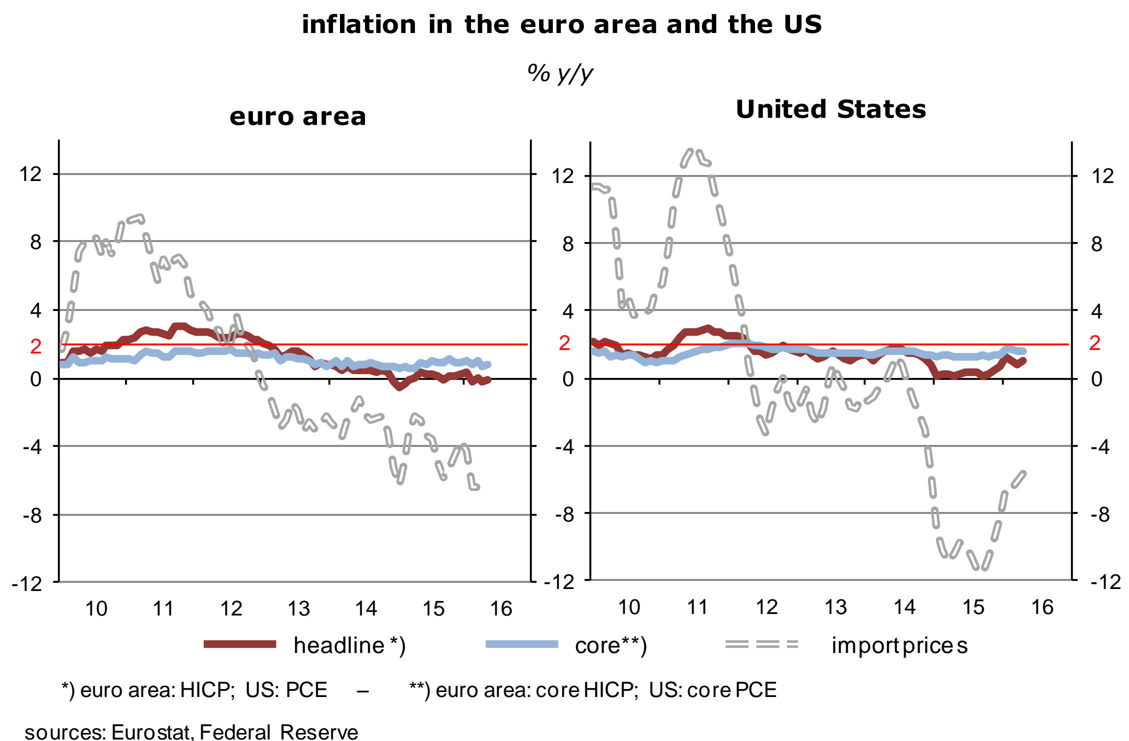
Asset markets dangerously dependent on central banks

by Dieter Wermuth*

1. Across the world, slow economic growth and the risk of deflation continue to be the main drivers of monetary policies. There are no signs yet that the recovery from the Great Recession has become self-sustained. Inflation remains very low but may be about to bottom out. **For central bankers, it is too early to give up their accommodative stance and to step on the brakes again.** This includes the United States. They wait for evidence that wages and prices are on a steady and robust upward trend.



2. Compared to earlier post-recession periods, and for reasons not well understood, record-low interest rates and the massive expansion of central bank money have not led to the desired increase in borrowing and spending on goods and services. Somehow the usual transmission channel from the monetary to the real sphere of the economy has been blocked. Since inflation remains below target, the Fed, the ECB, the Bank of Japan, actually all **central banks**

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in the rich countries, continue to pursue easy monetary policies. But most of the easing is probably behind us.

3. As it is, the main effects of these policies have shown up in financial markets. Unusually, equities, bonds and gold have simultaneously become expensive. This would not have happened if savers were simply betting on strong economic growth – in that case bond prices should fall, not rise. Rather, it is a sign that **too much money is chasing a limited number of financial assets which are expected to generate positive real returns.** Without a significant acceleration of capital spending, productivity growth will remain subdued, though, and with it the prospect that financial investors will achieve satisfactory income streams.

4. Not only this, there is the **additional risk of wide-spread profit taking: stock prices will collapse once these investors realize that profits will be less than expected, while bond prices may crash once inflation begins to accelerate again.** And gold? It is so expensive because people fear our economies are doomed, and because the opportunity cost of holding it is zero in this zero-interest world. But we know that in reality there are always fewer catastrophes than predicted, and that interest rates will certainly rise at some point again. Then gold is doomed.

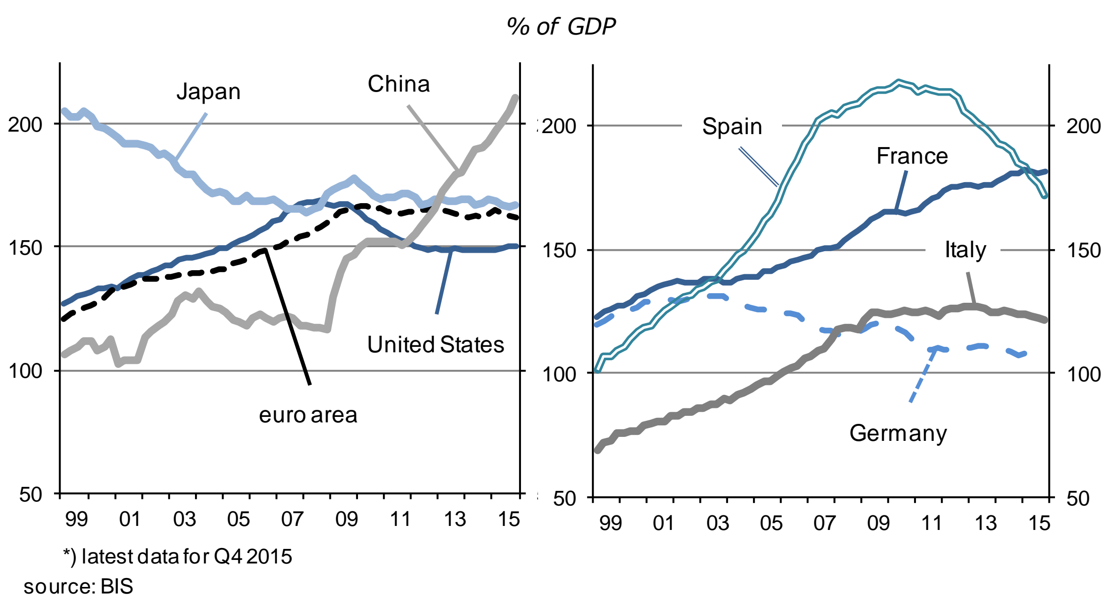
5. In other words, **most stocks, most government bonds as well as gold are too expensive**. It is only a matter of time before market participants will realize this and start a rush to the exits. Cash, “boring” high dividend stocks and some real estate markets are probably the best hedges against such an event.

China has found a new equilibrium, stabilizes rest of the world

6. As always, timing is the problem. **The likelihood of a new global recession and an imminent crash of asset prices has declined somewhat** since my last Investment Outlook, mostly because China’s economy is doing better than I thought. Compared to the heady days before the global financial crisis, China’s real GDP grows at a much slower rate. But at around 6½ percent – the new “normal” -, growth remains impressive; industrial production also expands at such a reduced rate. Imports have risen again (in CNY terms), after a 2-year slump, a sign that domestic demand has recovered, and sentiment indicators have not fallen into contraction territory after all. This has been a big relief for the world economy and the main reason for the turnaround of commodity prices.

7. **The country’s main risk remains private sector debt. Relative to nominal GDP it is now about as big as Japan’s at the end of the eighties, before the crash of asset prices** and the two and a half decades of very slow growth and deflation that followed.

8. For now, it has helped that the Beijing government pursues **slightly anti-cyclical fiscal policies.** The central bank (PBoC) is also in expansion mode: it keeps the policy rate significantly below the 7-percent growth rate of nominal GDP and is expected to reduce it by another 50 basis points over the next 12 months, to 3.85%. Other than in Japan 25 years ago, China’s problems are not exacerbated by a large appreciation of the exchange rate. Just the opposite: the yuan has depreciated from its high of CNY 6.05 per dollar in January 2014 to 6.58 now. This has contributed to the somewhat surprising resilience of China’s economy.



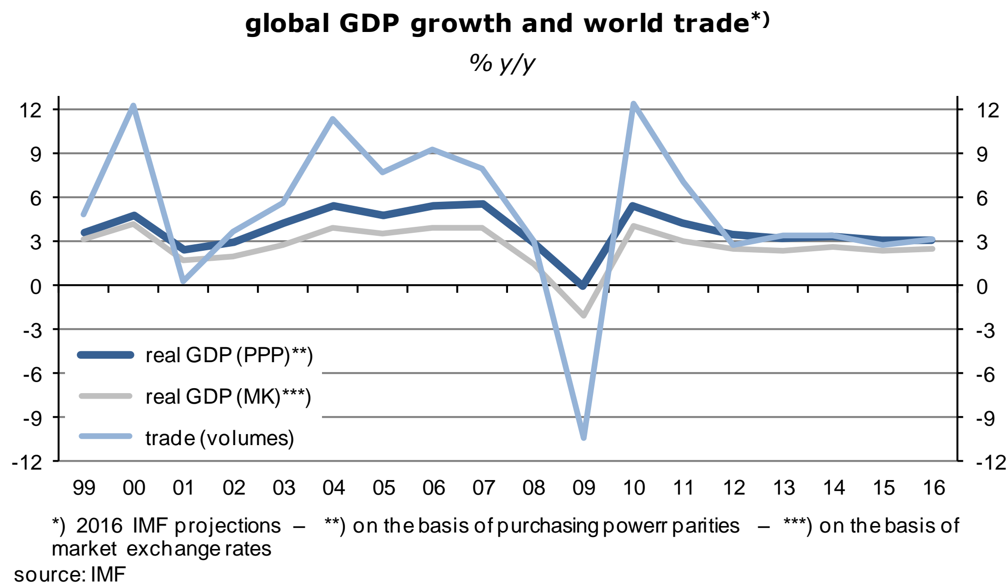
9. Things seem to work out, but the Damocles sword of **excessive debt will continue to pose a threat.** Any future recession will be made deeper and longer by efforts of the private sector to deleverage once the bubbles in housing, infrastructure and parts of industry have popped. Financial investors have to keep this in mind.

the productivity puzzle: smaller output gaps, smaller deflation risks

10. While China is an economic heavyweight and a main player in many markets, with a share of 17.1 percent in global "purchasing power parity" GDP and in this respect ahead of the US (16.2 percent), the rest of the world matters more. An **expected global growth rate of 3.2 percent this year** looks solid and even impressive from an OECD perspective – where growth will be only 1.7 percent – but it is still about 1½ percentage points less than the average before the financial crisis.

11. **Note a new phenomenon: world trade which for decades used to exceed global GDP growth by a factor of about 1.8, ie, to expand almost twice as fast as real GDP, will increase at a considerably slower rate this year (2.1 percent according to a new OECD forecast**; the IMF was still at 3 percent last April). Foreign trade and an ever more intensive international division of labor are no longer the world's growth engines. Domestic demand has become relatively more important; it could reflect the rising share of (non-tradable) services in global output or the substitution of trade by direct investments. It remains to be seen whether we are looking here at more than just a temporary phenomenon.

12. **Slow global output growth suggests that the gap between actual and potential GDP will not shrink. Unused capacities remain large which in turn makes it difficult to raise wages and prices and to achieve higher inflation rates. The risk of deflation will not easily go away in such an environment.**



*) 2016 IMF projections – **) on the basis of purchasing powerr parities – ***) on the basis of market exchange rates
source: IMF

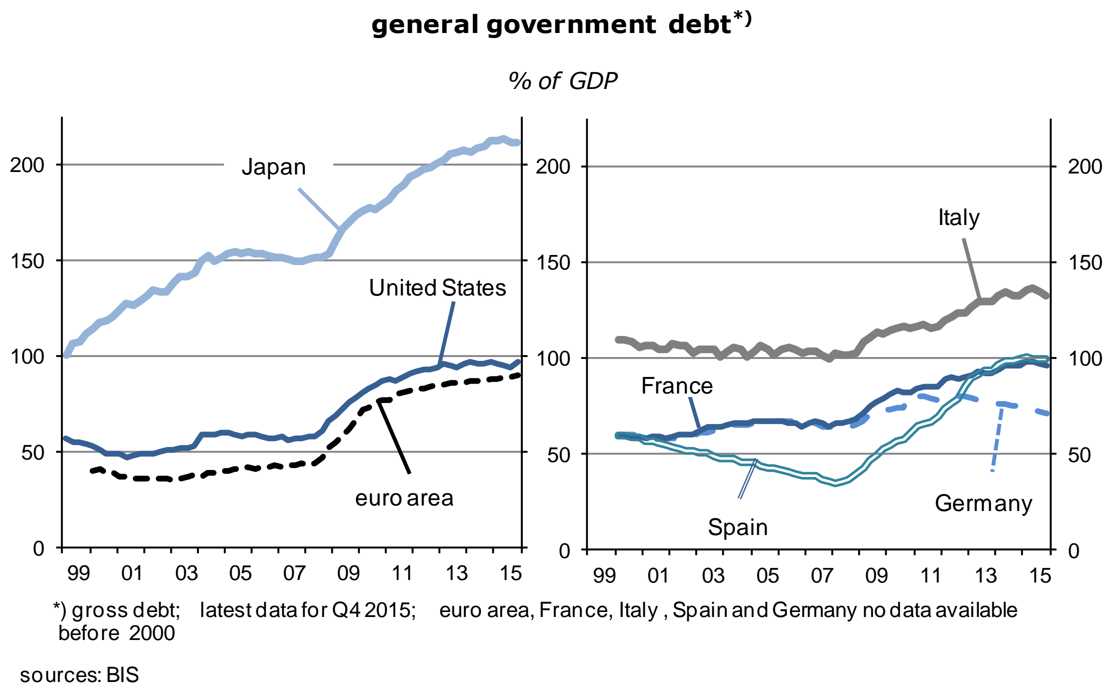
13. **I begin to wonder, though, whether I must adjust my long-held view of a rising output gap and, as a corollary, of a serious risk of global deflation.** It was based on the assumption that productivity growth would remain more or less unchanged over time. Together with trend employment it determines the growth rate of potential GDP. **There is now strong evidence that productivity has slowed significantly, and probably permanently. Potential GDP growth would therefore be slower as well – which reduces or even eliminates the deflation risk.**

14. Why should the pace of inventions slow, or the division of labor, or efficiency gains in production? Isn't the qualification level of the labor force improving all the time? But the longer productivity growth in industrialized countries stalls, the more it **becomes likely that something fundamental has changed** and that my assumptions were wrong.

15. **The numbers are impressive – and worrying**: in the US, average annual productivity growth (nonfarm business sector output per hour) has slowed from 2.4 percent between 1992 and 2007 to 0.5 percent since early 2011; in Germany "hourly output growth in the economy as a whole" has declined from 1.9 to 0.6 percent. The similarities are striking.

16. **What has happened? Since productivity is closely correlated with the growth rate of the capital stock, sluggish growth of investment spending in the aftermath of the financial crisis is the most obvious culprit.** This in turn may have mainly been caused by debt reduction processes in the US and much of the euro area ("deleveraging"); the need to repair their balance sheets had forced businesses and households to think twice before spending money on new projects.

17. Another **adverse factor has been restrictive (pro-cyclical) fiscal policies throughout euroland, not least in Germany** where the government had the ambition to achieve a budget surplus (it succeeded). An accelerated change of the structure of output, from goods to services, may also have played a role. In the service sector, the potential for productivity gains is smaller than in goods producing sectors.



*) gross debt; latest data for Q4 2015; euro area, France, Italy, Spain and Germany no data available before 2000

sources: BIS

18. In any case, the significant **slowdown of productivity growth is the most important reason for the dramatic decline of real interest rates** on financial assets. Only a new investment boom can change that trend. For now, investors must familiarize themselves with the thought that, on average, profit growth will never be as fast as it used to be.

the tentative case for rising inflation rates

19. **In the US**, annual employment growth has averaged about 1.6 percent after the crisis; combined with the 0.6 percent growth rate of productivity, it yields a **potential real GDP growth rate of 2.2 percent, down from 3.0 percent in the decade before the Great Recession**. Those 2.2 percent are almost identical to the actual GDP growth rate of 2.0 percent in the five years through 2015. In other words, the output gap between actual and potential GDP has essentially been unchanged and cannot be used as an explanation for the recent increase of US inflation. It has certainly not shrunk.

20. **The pick-up of inflation has more to do with wages**: hourly compensation in the US nonfarm business sector has lately increased to 3.7 percent y/y; it reflects the booming labor market – employment has been up 1.7 percent y/y in May. Quickly rising wage inflation, together with rising import prices (+1.8% saar between Dec. and May) have begun to push US core (PCE) inflation above 2 percent and thus above target. The Fed has room to raise interest rates more quickly. That it hesitates is a sign that it is afraid of a new recession.

21. Post crisis, **German trend growth of employment has been a little less than 1 percent**; multiplied with the new productivity trend of 0.6 percent results in a medium-term rate of potential GDP of 1.6 percent which is identical with actual GDP growth over the past five years. Again, things closely resemble those in the US. **The output gap has thus basically been unchanged and cannot be used as an explanation why German CPI has increased at an annualized rate of 2.0 percent between January and May this year (core CPI: 1.4%)**. The acceleration of headline inflation can partly be explained by the fact that import prices are no longer falling. More importantly, German wage inflation is on the rise. In Q1, year-over-

year hourly labor costs have been up by 3.1 percent while the annualized rate between Q4 and Q1 has been no less than 6.9 percent. These numbers are calculated from seasonally adjusted Bundesbank statistics.

22. **It is too early to conclude that deflation has been conquered. This may be the case in the US and in Germany, but in Japan and in the euro area as a whole the fight has not yet been won.**

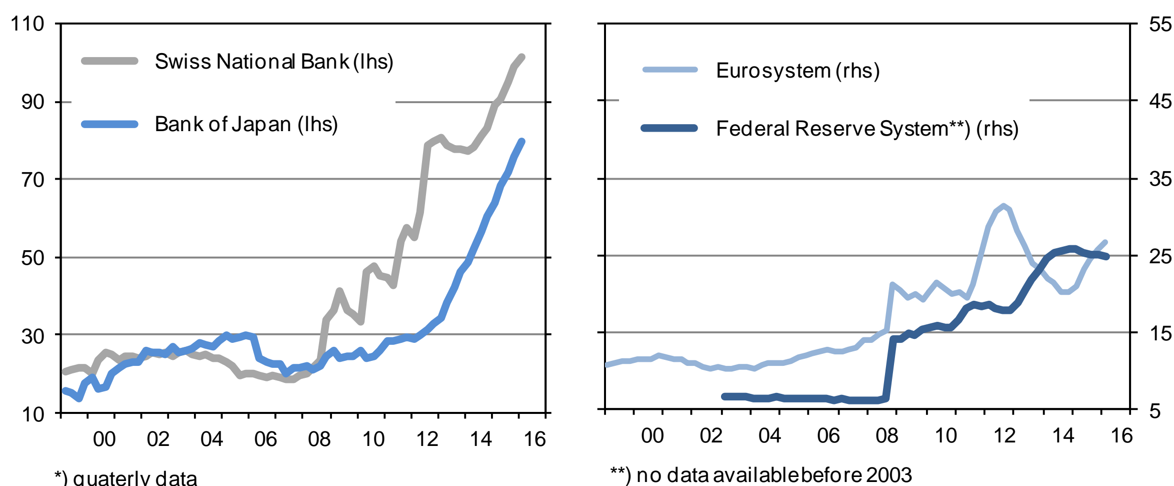
23. With European unemployment still at 10.2 percent, and youth unemployment (< 25y old) of no less than 21.1 percent, there is plenty of slack in the labor market; on the ECB's most recent count (Q4 '15), average hourly wages were up only 1.3 percent y/y. To get closer to the present, I calculated the average for four countries on the basis of more recent, if not totally comparable data: France (Q1), Italy (April), Spain (Q1) and the Netherlands (May). The result was 1.4 percent y/y. Spain was strongest (3.4%), Italy weakest (0.6%).

24. It's still way below pre-crisis wage inflation rates, but **in real terms, wages outside of Germany are now rising by about 1½ percent.** Since euro area employment in Q1 has exceeded its year-ago level by 1.4 percent (in the five years to Q4 2013 it had been shrinking!), it has become more likely that wages in the euro area as a whole will rise more briskly – and that consumer price inflation will follow suit.

The Fed will raise policy rates further this year, the ECB will wait until next spring

central bank balance sheets

total assets as % of annualized GDP)*



*) quaterly data

**) no data available before 2003

sources: SNB, Bank of Japan, ECB, Federal Reserve; own calculations

25. On the basis of such numbers, **the ECB is not under pressure to become even more expansionary. Deflation looks less of a risk.** Nevertheless, the €80bn per month asset buying program will continue as planned, ie, through March 2017. To put these numbers into perspective: annual purchases amount to €960bn while this year's aggregated euro area general government deficit will be in the order of €200bn. Total euro area government debt will be €10,000bn at the end of 2016 (92.5% of the €10,800bn nominal GDP). If the monetization of government debt were to continue at the present pace, it would take the EZB less than a decade to become the only creditor of euro area governments. It won't

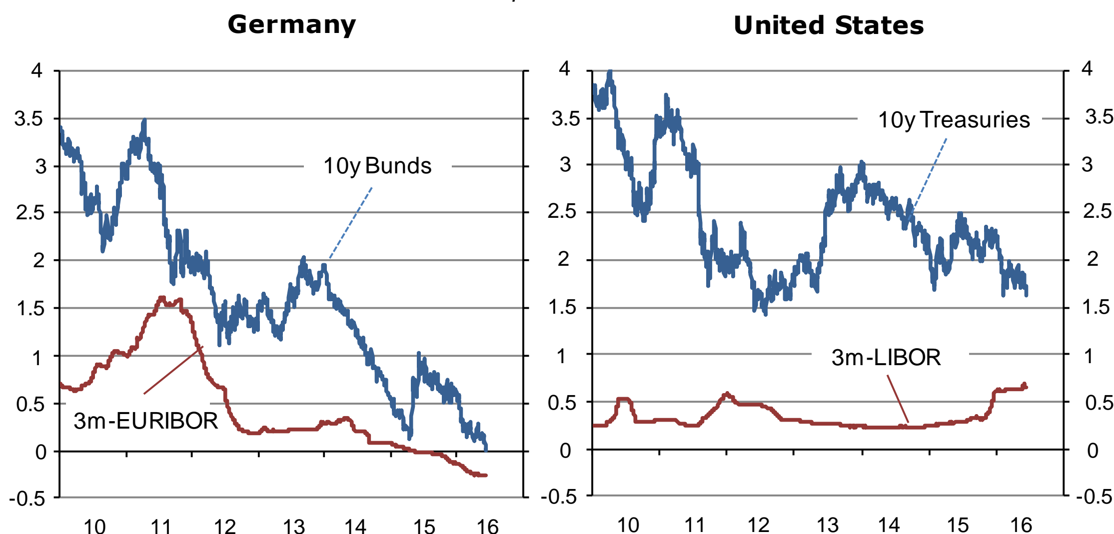
happen, of course. I actually think that **the ECB will stop next March and then allow interest rates to rise again.**

26. **Some of the purchases now consist of corporate bonds. It means that the ECB plays capital markets by bypassing the banking sector. It behaves like an institutional long-term investor**, comparable to a sovereign wealth fund or a pension fund. Since European corporate bond markets are underdeveloped and not very liquid, the ECB must be active in the so-called primary market, ie, negotiate purchases directly with the issuers. Eligible bonds must be rated "investment grade" by at least one of the big rating agencies. Meanwhile, issuing activity in the corporate bond market has picked up strongly, and spreads vis-à-vis government benchmark bonds have shrunk.

27. **Whether a central bank should do this is another question. It's part of Draghi's strategy to "do whatever it takes" to stabilize the euro**, in this case to boost business spending, investment spending in particular. It is a response to the breakdown of the transmission mechanism that is supposed to connect monetary policies with the real economy. It also gives a welcome shot in the arm of a long-neglected and underdeveloped section of the European capital market.

the bond market boom: the end is near

28. The massive purchases of euro area bonds by the ECB, the slowdown of productivity growth and the flight to "safe" assets have pushed yields down a lot. A few days ago, Germany has at least temporarily joined the select club of Switzerland and Japan where **the entire yield curve of government debt, from money market instruments to 10-year bonds, is in negative territory.** Investors are de facto paying a fee for the privilege of holding these securities. 10-year Bunds are now at +0.05%.

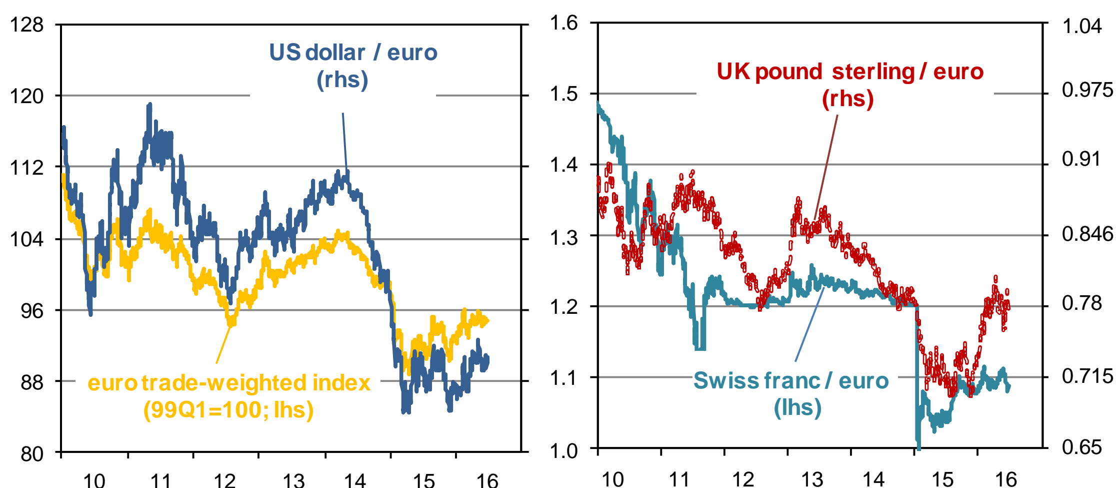


29. **This must not be the end – Swiss government bonds are at -0.5%. Incidentally, such a low rate has been achieved without any sfr-bond purchases by the SNB, the central bank (see**

the diagram on page 6). In relative terms, its balance sheet has expanded by much more than that of the ECB, but it has been the result of interventions in the foreign exchange market, ie, of purchasing euro assets. Swiss bond yields are at a world record low because inflation is -0.4 percent y/y, and because of the status of the Swiss franc as a safe haven currency.

30. **As an observation on the side, Switzerland's economy hardly grows, but its GDP per capita is almost twice as high as Germany's** (€72,000 vs. €38,400; estimates for 2016) – as a country you get rich by letting your currency appreciate and making sure the structure of your economy and the skills of your labor force keep adjusting to the competitive pressure from abroad. The Swiss unemployment rate is just 3.5 percent. If the Swiss can do it, can others also do it, I wonder? It's certainly an otherworldly performance.

exchange rates



source: ECB

31. **The question is when the bond market boom will end**. I have already said that the US Fed has considerable room for manoeuver: core inflation has reached its target value and full employment has been achieved. The FOMC cannot continue to set ever lower targets for the unemployment rate. Seasonally adjusted, it has been at 4.7 percent in May, steadily down from the 9.9 percent peak in December 2009.

32. **At some point, the next interest rate step has to be taken (the second after Dec. 2015). It cannot be excluded that dollar bond markets will then crash**, but the coming move has been well advertised and market participants had enough time to prepare. Foot-dragging is actually more risky for the Fed: price and wage inflation might have accelerated dangerously by the time of the next rate hike; market participants would anticipate larger steps than they do now and thus sell their bonds more aggressively. A dollar appreciation would be another predictable effect.

33. Might the Fed try to coordinate a further tightening with the ECB? Unlikely - because European inflation is not going to accelerate quickly to the 2 percent target. Unemployment is much too high. **My best guess is that Mario Draghi will not step on the brakes before April 2017 while the Fed will hike two more times this fall. When they come, bond markets**

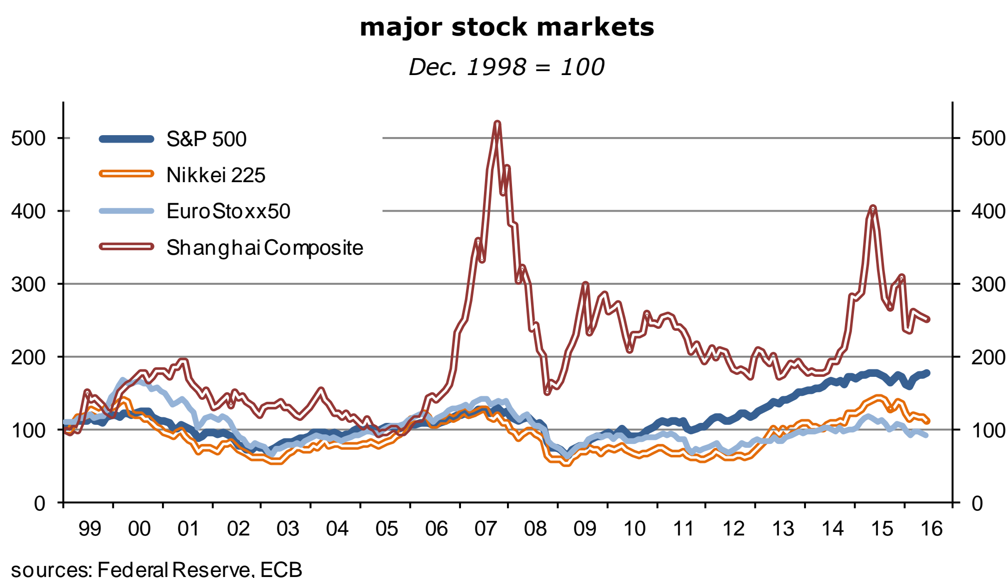
across the globe will suffer, including those of the euro area, and they will suffer even more when the ECB starts to tighten as well. A year from now, 10-year US Treasuries may yield 3½ % while 10-year Bunds could be at 1½ %. Even higher yields would lie ahead. A "normal" 10-year is the product of the new productivity growth rate of 0.6 percent, the target inflation rate of 1.9% and a term premium of, say, 100 basis points, ie, 3.5%.

Equities are also expensive

34. Weak bond markets inevitably go along with weak stock markets. As the real yield of "riskless" assets (government bonds) rises, the risk premium built into stock prices shrinks. **To re-establish the premium, stock prices need to fall. At this point they are quite elevated so it will not take much to send them down.**

major stock markets

Dec. 1998 = 100



sources: Federal Reserve, ECB

35. The average **price-to-earnings ratio** of the companies in the S&P 500 is 19.2 (based on the earnings of the past four quarters); the EuroStoxx 50 is at 21.4, the DAX at 21.7, and the Nikkei at 19.0. All of these numbers are **significantly above their historical averages**. It reflects the strong demand for stocks in response to ample liquidity and lackluster capital spending. Among large stock markets, **China, with its p/e ratio of 13.6, looks relatively cheap**: the decline from the bubbly market high of June 2015 has been no less than 42 percent. Hype about ever-lasting real GDP growth in the order of 10 percent a year has been followed by a crash which has brought stock prices back to more reasonable levels. For the time being at least, China's policy makers have succeeded to stabilize the economy around a lower yet still very high growth path.

36. **Price-to-book ratios convey a similar message as p/e ratios**: 2.8 times for the S&P 500, (a more modest) 1.3 for the EuroStoxx 50, 1.5 for the DAX and 1.5 for the Nikkei. On the basis of this metric, American equities in particular are quite rich: market participants have priced in a robust and long-lasting growth of corporate earnings. US stocks also have a rather low **dividend yield** (2.2%); it is not much higher than the yield on 10-year Treasuries (1.7%). Investors are better protected from a cash flow perspective if they opt for stocks of the EuroStoxx 50 or the DAX; there, average dividend yields are 4.2% and 3.2%, respectively.

37. Stocks may look expensive at the moment, but **it could be that their prices will soon be vindicated by strongly rising profits. How about it? A back-of-the envelope forecast** goes like this: use the expected producer price inflation rate as a proxy for the change in the revenue per unit of output and compare it with the three main cost components of the production function: labor (unit labor cost), imports (import prices) and capital (the cost of equity and debt).

38. **Take for example the US in 2016**. PPI will be around +0.5% y/y; unit labor costs in the business sector will rise faster than that, because of higher wage inflation and poor productivity, perhaps by 3% y/y; as mentioned earlier, import prices are not decreasing any more, but they will still be down by an average of about 5 percent from 2015; the cost of debt will be more or less unchanged, the same as the cost of equity. Since wage costs account for roughly 60 percent of total cost, they dominate the outcome. According to this heroic calculation, unit costs will exceed their 2015 average by 0.1 percent. Since unit revenues will be up 0.5 percent, I would expect a small increase in unit profits. But it's nothing to write home about. **US stock markets are not supported by a strong growth of profits – they are therefore simply overvalued.**

39. Similar calculations for the other three markets represented in the previous graph – the EuroStoxx 50, the Nikkei 225 and the Chinese CSI 300 – suggest that profits will rise moderately at best, and certainly not strongly enough to support rallies.

beware of banks and fossil fuels

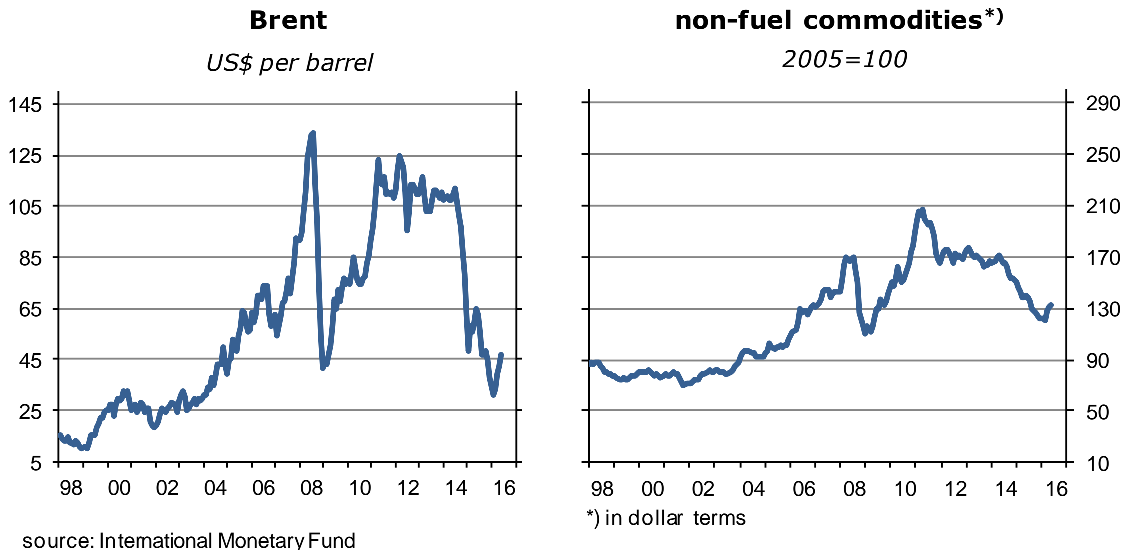
40. Two sectors have been in secular decline across the world: banking and fossil fuels.

41. **Banks have seen their interest margins decline dramatically as returns on their assets have shrunk a lot faster than the cost of funds** (which cannot fall much below zero given that there is still so much cash around). Income from the asset side of their balance sheets has been hit by the fall of inflation expectation in the persistently disinflationary environment, but also by the reduction of productivity growth which in turn had a negative effect on real interest rates.

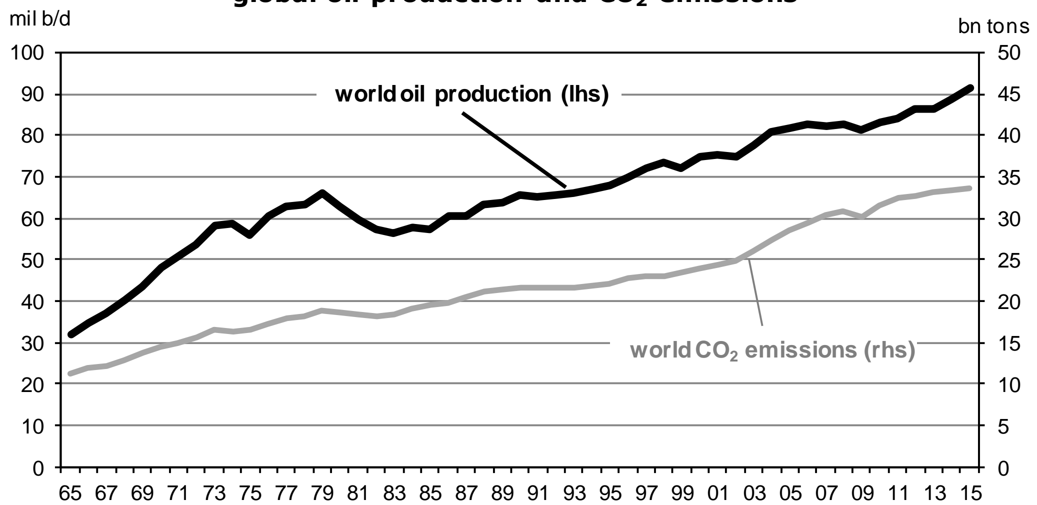
42. Compared to pre-crisis conditions, interest margins in OECD countries have been cut by half, or more. The most reliable source of income has dried up. In addition, banks are about to lose a large chunk of their bread-and-butter business to newcomers which attack them via the internet. These **developments force banks to reduce overhead expenses**, ie, to lay off staff, close branches, seek to merge with competitors, sell the least profitable assets and shrink their business in general. The rich countries have been overbanked, and they might still be.

43. As the sector shrinks, the surviving banks will not necessarily be smaller than before 2008. Internal incentives are still more or less as before the crisis, and banks are still highly leveraged. Established nonfinancial firms have learned the hard way that they need to be careful with leverage and keep large cash cushions. Not **so the banks. They continue to be a risk for the stability of the global and national financial systems**, a not-so-welcome side effect of the ongoing and necessary structural changes. As MIT's Simon Johnson has recently

argued in his blog, "we are in for another stomach-turning round on the global economy's wild ride". Buyers of bank shares should not be risk averse.



44. **Equally dramatic developments have taken place, and will continue to take place, in the energy sector. Oil prices have slumped from $115 in mid-2014 to $48 now.** Earlier predictions have proved wrong: that the world was about to run out of the stuff and that prices were going only one way: up. As it happened, production has increased more or less every year, on the supply side in response to aggressive exploration and fracking, on the demand side by the steady increase of global GDP. Oil is not in short supply.



45. From an economic point of view there is no upper limit to oil output – it is just a matter of price. Recently, world real GDP has expanded at rates of about 3 percent while oil production has grown at rates in the neighborhood of 1 percent. **In rich countries, oil demand is not rising anymore, or by less and less. Today's main drivers are the emerging economies;** since

daily life there is not very energy-intensive yet, they will remain in catching-up mode for some time. Their oil consumption is not about to peak in the near future.

46. **But the point where oil demand and oil production will actually start to decline on a global scale may be nearer than generally expected.** Several developments are coming together: 1) thanks to technical progress and economies of scale, alternative electricity from wind and, especially, sun has become increasingly cheap and competitive, even without subsidies; 2) at the climate conference in Paris last December, governments have made strong commitments to reduce greenhouse gas emissions, ie, to rely less on burning fossil fuels at power plants and in transportation; 3) air pollution in countries like China and India has become so bad in the wake of rapid economic growth that even there a broad consensus is building to switch to clean energy; 4) energy efficiency is improving quickly in housing and the production of goods and services; 5) storage technology is close to a breakthrough which suggests a bright future for decentralized small-scale and cheap alternative energy production.

47. In other words, an **ample supply of oil and other fossil fuels, caused by the high and rising prices between 2004 and early 2014 (the "carbon bubble"), combined with long-term trends that slow demand will probably keep oil prices low for good**. Production and consumption will become less fossil fuel-intensive. Upstream and downstream oil companies as well as utilities and ship owners have to write down large portions of their capital stock and the reserves in the ground. With revenues less than half as high as expected only two years ago, their market value has declined steeply. Profound structural changes are underway and will continue. Some of the companies are still in a state of denial and thus risk to be swept away.

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