



Wermuth's Investment Outlook

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Sell bonds, buy stocks

by Dieter Wermuth*

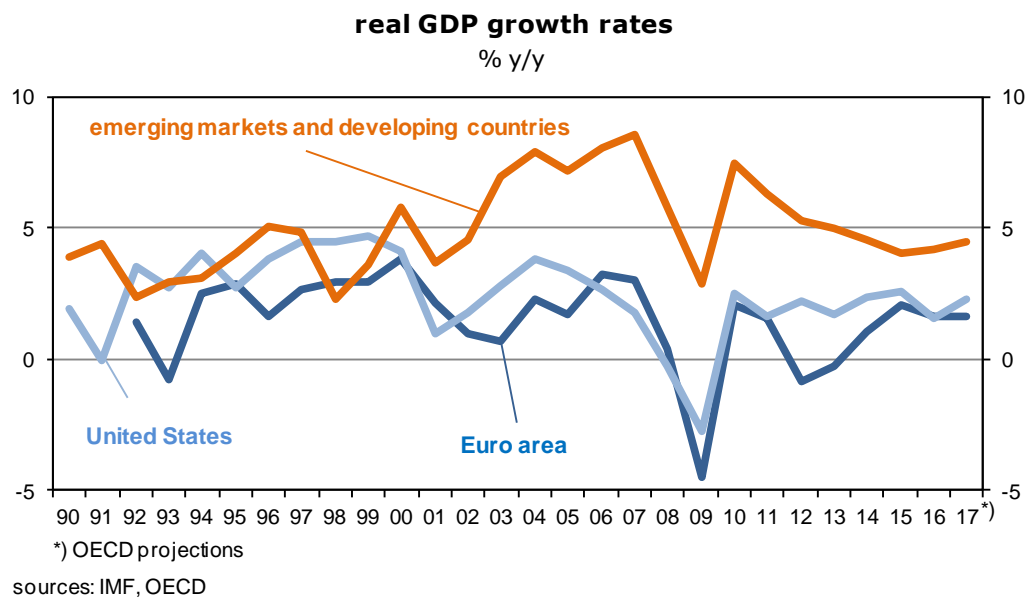
1. **This year, asset markets will be driven by two or three rate hikes in the US, an initially strong dollar, followed by a depreciation that is overdue by now, further aggressive money printing in the euro area and Japan until the middle of the year, before the ECB starts hiking policy rates, relatively robust global GDP and employment growth and a gradual increase of actual inflation and inflation expectations across the OECD area. Fiscal policies will continue to stimulate growth – a lot in the US and China, and moderately in the euro area and Japan.**
2. **The price decline of overvalued assets, especially of safe-haven bonds, will probably be another market driver.** Crude oil and other commodities are fairly expensive by now and have more downside than upside potential which means the terms of trade of commodity importing countries will improve again and thus stimulate their economies.
3. In general, equities are also quite expensive but since they are real assets they are to some extent protected against rising inflation rates; many of them pay handsome dividends. They are, of course, hurt by rising interest rates because these mean higher financing costs and lower present values of future earnings which reduces their upside potential. Even so, **equities will do better than fixed-income securities.**
4. There are **four main risks**: a new euro crisis, protectionist trade policies, debt problems in emerging and developing economies, and a crash in China. As usual, most risks will not materialize, or not in the near future. But they all have the potential to disrupt markets for goods, services, labor and capital, and thus cause recessions. They must therefore be monitored carefully.

Global growth rate stable at around 3 percent

5. “Robust” global GDP growth means a year-on-year rate of 2.9 percent in 2016 and 3.3 percent in 2017. These are the latest OECD forecasts. **So far the world economy has not succeeded to return to the growth standard of 4.2 percent a year before the financial crisis:**

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on average, advanced countries are lumbering along at a rate of somewhat less than 2 percent, compared to 2.8 percent before 2008, while emerging market and developing economies have slowed from 5.8 to about 4 percent.

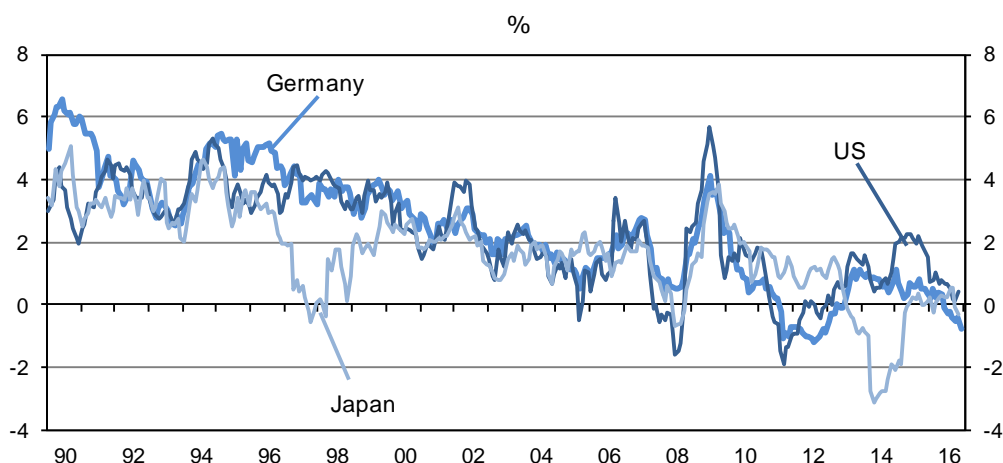


6. **For the OECD, the global economy is stuck in a low-growth trap of around 3 percent for five years now:** “Persistent growth shortfalls have weighed on future output expectations and thereby reduced current spending and potential output gains. Around the world, private investment has been weak, public investment has slowed, and global trade growth has collapsed, all of which have limited the improvements in employment, labour productivity and wages needed to support sustainable gains in living standards.” (Economic Outlook, 28 November 2016, Press Conference, p.4)
7. I am less pessimistic. **Perhaps a growth rate of 3 percent is the new normal, and it is not really so low from a long-term perspective.** In volume terms, global GDP would double every 23 ½ years if such a rate can be maintained. For today’s newborns, an increasingly small part of that 3-percent growth rate will be accounted for by population growth – as a function of per capita income, it will decline from 1.3 percent a year in 1990 to 2013 to 1.0 percent in 2013 to 2030 (UN Department of Economic and Social Affairs).
8. In other words, living standards will continue to rise; at the same time, the catching-up processes of the less developed countries have still a long time to run. **Since there is growth, there will be plenty of opportunities for those who provide the funds.**

Bond yields will continue to rise

9. **It is not so much sluggish economic growth that will limit future returns on financial investments but rather the rich valuations of bond and stock markets.** A “normal” real yield of liquid top-grade 10-year government bonds is probably in the order of 1 ¾ percent which is the product of productivity growth of around 1 percent and another three quarters of 1 percent for the premium for holding volatile long-term rather than short-term debt.

real 10-year government bond yields*)



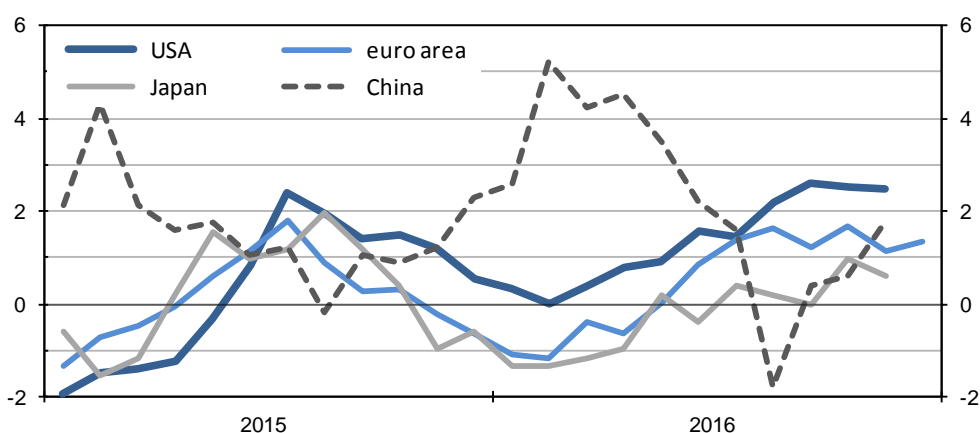
*) 10y government bond yield minus annual CPI inflation rate

sources: Deutsche Bundesbank, Federal Reserve, ECB; own calculations

10. As it is, actual real yields are dramatically lower than that. In Germany, they are at -1.0% (= 0.2 – 1.2), in France at -0.6% (= 0.65 – 1.25), in Italy at +0.8% (= 1.75 – 0.94), in the UK -1.8% (= 1.23 – 3.02), in the US +0.5% (= 2.44 – 1.97) and -0.55% (= 0.04 – 0.6) in Japan. The second numbers inside the brackets are 10-year break-even government bond yields as shown on Bloomberg on January 2 (code no. ILBE) – they represent long-term market expectations of consumer price inflation. **Only real Italian and American bond yields are in positive territory but they are nevertheless well below their equilibrium levels and are thus bound to correct some more. All other bonds, with their negative real yields, are even more overvalued.**
11. Any “normalization” of real yields implies a very large decline of bond prices. Since inflation has recently been picking up in the euro area and the US, including core inflation, there are signs that such a process is now under way.

consumer prices

%, 6-month annualized rates of change*)



*) annualized rates for China and Japan are based on time series that are not seasonally adjusted

sources: Federal Reserve, Eurostat; OECD; own calculations

12. **While only the Fed is actively raising policy rates I expect the ECB will reconsider its quantitative easing strategy in due course and start tightening the reins as well. This**

suggests that the allocation to bonds should be reduced to below par. In advanced countries, the turning point in bond yields was sometime in July and August 2016 – since then 10-year government bond yields have risen by about 40 basis points in Germany and Japan and, at the other end of the range, by 80 to 110 basis points in the UK, in Italy and the US.

Looking for the best yardstick to evaluate equities

13. The question is whether it is already too late to increase the portfolio allocation of equities. These have generally performed very well in the past. Assets which have gained a lot already are, as common sense tells us, likely to disappoint.
14. The following table shows that stock indices have outpaced the expansion of nominal GDP by large margins. The only major exception is China where the correction of past stock market excesses continued while economic growth held up very well (on average 8.3 percent a year).

major stock markets: performance and valuations

market	5-year performance ¹⁾ (%)	price-to-earnings	price-to-estimated 2016 earnings	price-to-book	risk premium ²⁾	nominal GDP 2011-2016 ³⁾ (%)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
S&P 500	78	21	17.2	2.9	5.3	19.7
Euro Stoxx 50	42	21.3	14.2	1.6	7.8	9.5
DAX	94	18.2	13.6	1.8	8.4	15.3
CAC 40	54	24.1	14.5	1.5	7.6	8.0
FTSE 100	28	60.6	14.7	1.9	7.6	19.6
Nikkei	126	24.9	19	1.8	5.8	8.1
CSI 300 ⁴⁾	41	14.9	12.6	1.8	7.9	49.1

1) end 2011 to end 2016 – 2) For the calculation of the risk premium, expected inflation rates according to market breakeven yields were used. Euro area expected inflation rate is calculated as the average of German, French and Italian breakeven inflation rates. Chinese expected inflation rate is the 5-year inflation forecast by the IMF. – 3) 2011Q3 to 2016Q3 – 4) Shanghai Shenzhen CSI 300 Index

sources: Bloomberg, own calculations

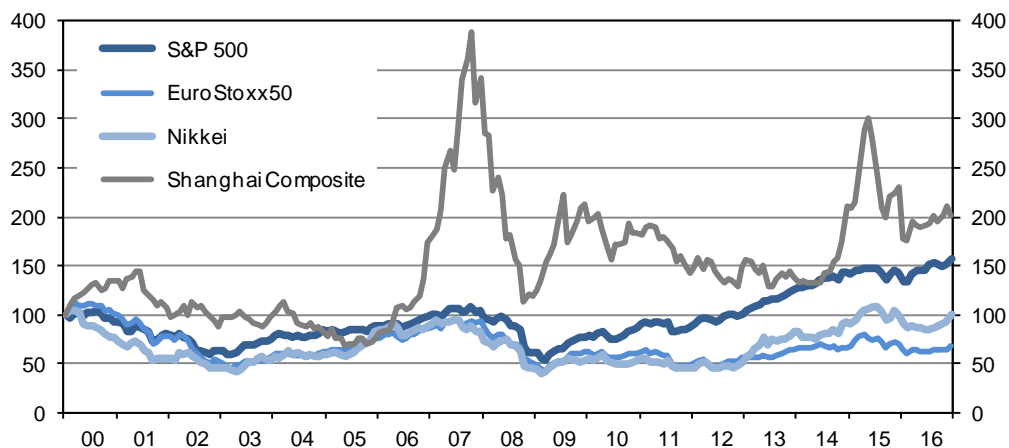
15. Looking at the 5-year period from the end of 2011 to the last day of 2016, the **discrepancy between stocks and nominal GDP** is particularly large in Japan, followed, at some distance, by France and Germany.
16. But this is, of course, just one yardstick among several possible ones to determine whether a market is cheap or expensive. According to the **price-to-book** ratio, the US market is hugely overpriced (at a multiple of 2.9); at the other end of the range are France's CAC 40 and the Euro Stoxx 50.
17. The most popular metrics are **price-to-earnings ratios**. Using actual earnings per share, as published by the companies that make up an index, British stocks are extremely overpriced, followed by the Japanese. Chinese stocks, on the other hand, seem to be good buys. Things

look somewhat different again on the basis of 2016 earnings per share, as estimated by analysts. According to this statistic, the British market is not the most expensive one anymore (column 4). That distinction goes to Japan, with the US a close second. China is least expensive once again.

18. How attractive are stock markets vis-à-vis their domestic bond alternatives? The metric that answers that question is called the **risk premium**. It represents, in terms of percentage points, the difference between a stock market's earnings yield (the inverse of the p/e ratio) and the real long-term yield of riskless (government) bonds. In the decades before the global financial crisis, risk premia of 4 to 6 percentage points were considered to be normal – higher values suggested that equities were cheap, and vice versa.
19. **Now only the 5.3 pp risk premium of America's S&P 500 and Japan's 5.8 pp are near historical averages while all others exceed these by a wide margin (7½ pp and more).** The higher the risk premium the more risk is priced into a market, and the larger the cushion against a crash. Here the German DAX beats the competitors in the table, but China's CSI 300, the Euro Stoxx 50 and the French and British indices are not far behind.
20. So what to make of this mixed bag of messages? In general, there is little evidence of stock market bubbles in the major countries. **Equities are cheap compared to bonds**, and they are particularly cheap in relative terms if I am right about my expectation that inflation is on the way up and that central banks have begun, or will soon begin, to raise policy rates, leading to large declines of bond prices.

major stock markets

Jan. 2000=100



sources: Federal Reserve, ECB

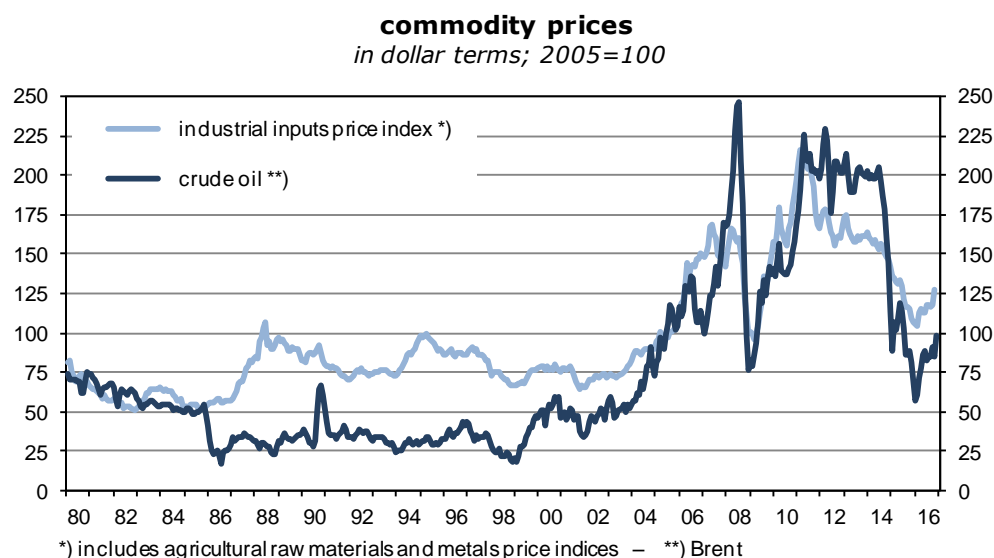
21. **The most expensive stock market is the US:** it reflects the dollar's safe haven status. Next in line is Japan where market participants have been enthusiastic about the positive effects of the weak yen on corporate profits; they are obviously not concerned about the possibility that the yen may just as well appreciate again – the country's fundamentals are fairly good. **China is cheapest:** somehow investors are not impressed by the 12.2 percent depreciation of the yuan (from its low of 6.04 per dollar in January 2014 to 6.88 today). Instead, they worry about capital flight, reflected in the decline of foreign exchange reserves by almost 1 trillion dollars to \$3.05tr in just two and a half years, and are scared about risks such as political

interference in the corporate decision making process, the extent of leverage and the looming trade war with the US.

22. Europe has a bad press and is therefore relatively cheap as well: will the euro blow up after the Dutch and French elections this spring, and can Italy's non-performing loan problem be contained? Experience suggests that Europeans have a tendency to let things drift, to procrastinate, but when driven to the brink solutions will be forthcoming. Unlikely that it will be different this time. In other words, **the perceived risk of holding European equities is larger than the true risk**. In reality, the aggregated numbers for the euro area's balance on current account and its government debt level and deficits are rather impressive. Not to forget, the ECB will stand by its promise to do whatever it takes to save the euro – after all, it has a money printing press downstairs.

Stay away from fossil fuels

23. **Last year fossil fuel companies were among the stars of the stock markets**, together with the leading global banks. They had been clobbered since the middle of 2014 when oil prices began their steep descent from \$127 to \$26. In early 2016 they staged a dramatic recovery, again in parallel to the oil price which has now reached \$56 (Brent). Impressive as the gains have been, they will prove to be temporary.



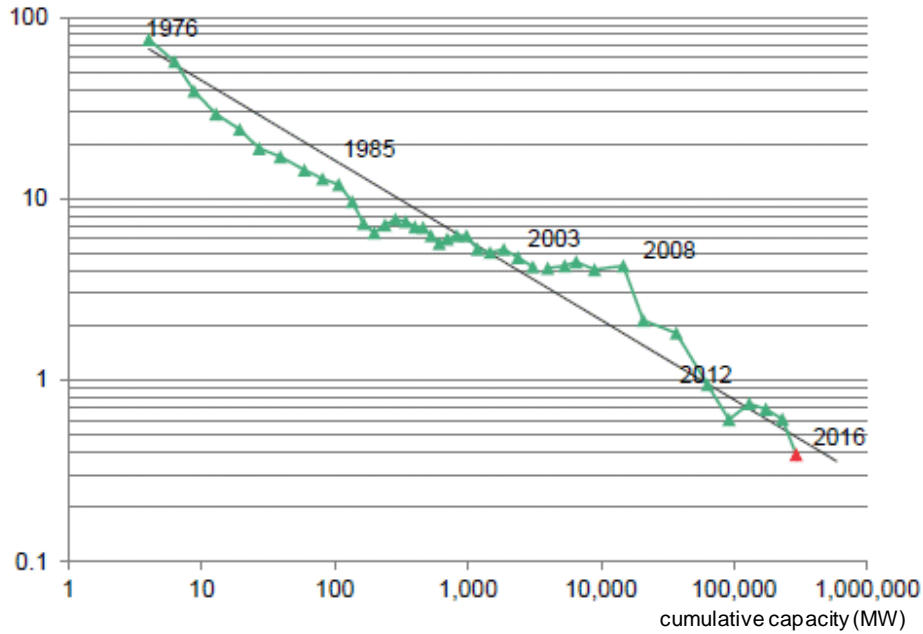
source: International Monetary Fund; own calculations

24. The **megatrend which increasingly revolutionizes energy markets** is the steep and steady decline of the cost of alternative energy. In the following two graphs which use a double log scale presentation – a binary log on the y-axis and a log 10-scale on the x-axis – the cost curve is shown as a function of installed capacities.
25. Electricity from sun and wind gets cheaper as economies of scale kick in. The viability of alternative energy is probably no longer dependent on government subsidies – market forces and regulations for the protection of the environment have taken over as drivers of the green revolution. If the trends do persist for the next decades – which I expect - oil, gas and coal prices must fall as well. Any increase, such as in 2016, must therefore be seen as part of

a fluctuation around a falling trend, not a trend reversal. **The future of fossil fuel assets is rather bleak, and any significant price increase should be used to sell them.**

solar PV module cost

Dollar/W

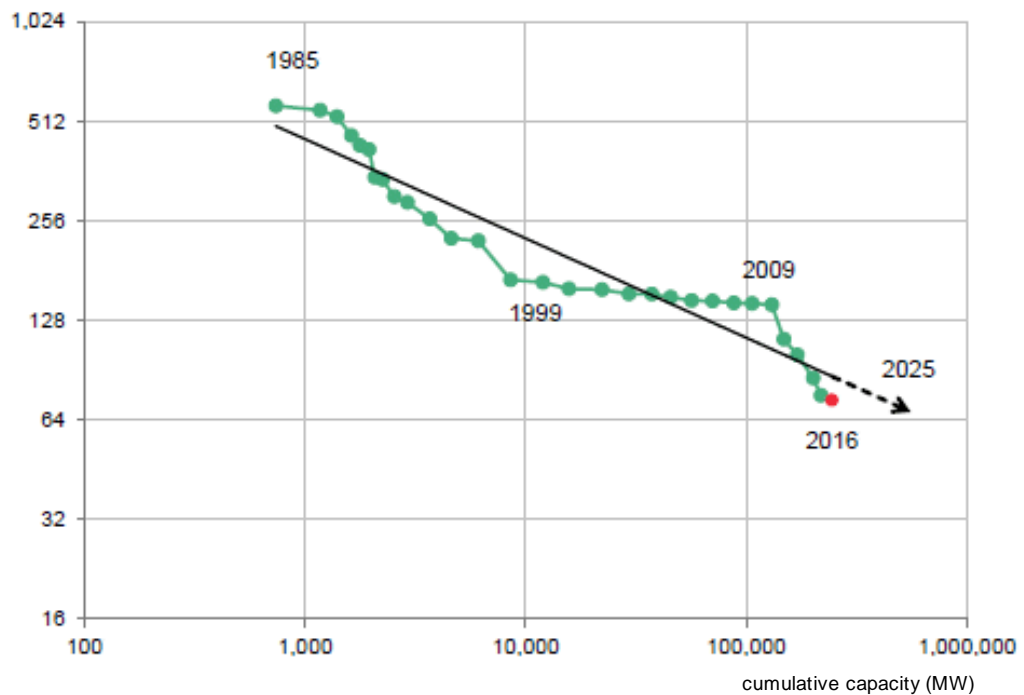


note: prices are real (2015) USD. 'Current price' is \$0.4/W

source: Bloomberg New Energy Finance

northern Europe onshore wind levelised cost

Dollar/MWh

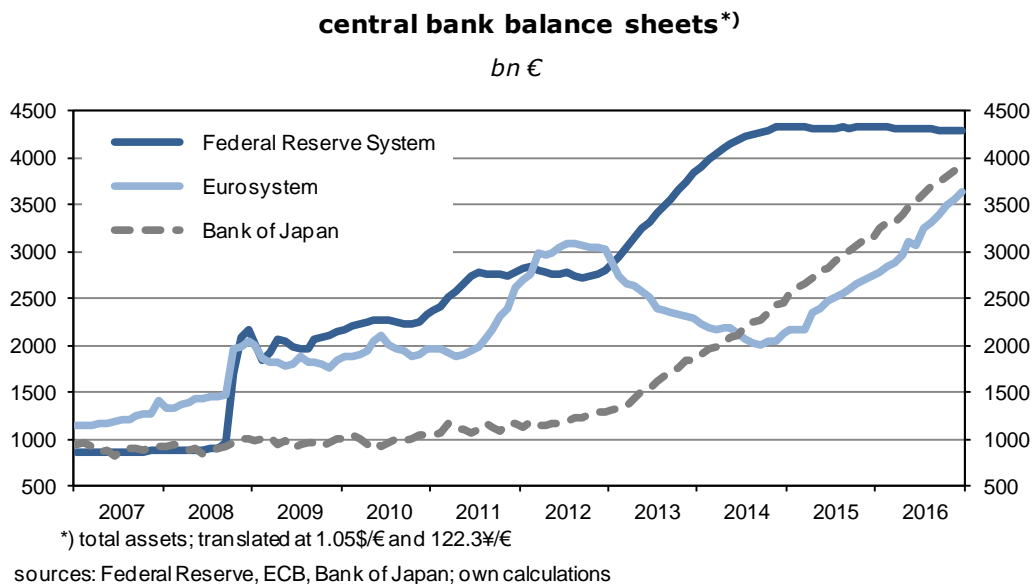


note: pricing data has been inflation corrected to 2014. Assumptions: a debt ratio of 70%, cost of debt (bps to LIBOR) of 175, cost of equity of 8 %

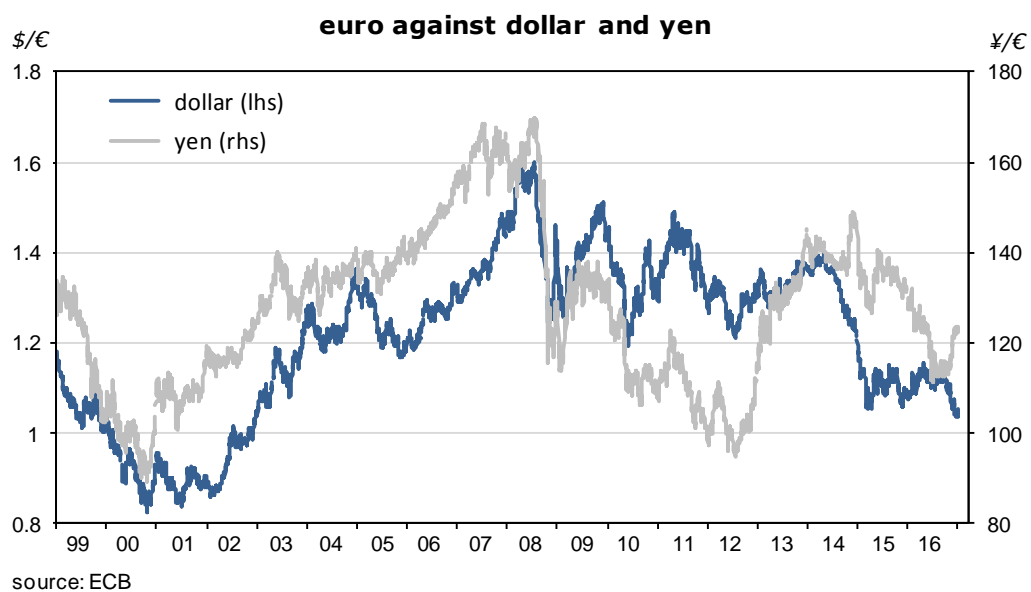
source: Bloomberg New Energy Finance

ECB will raise rates this year

26. Let's now turn to monetary policies. Mario Draghi, the president of the ECB, has announced last month that quantitative easing will continue after its first expiration date next March. Monthly net purchases of government and corporate bonds will be reduced to €60bn a month, from €80bn at present.



27. If necessary, the ECB stands ready to extend QE beyond next December and to include new assets. It seems that an early tightening of monetary policies is not on the bank's radar screen at all. It should be, for several reasons: **between May 2014 and today the euro has gone from \$1.39 to \$1.05**; this has contributed significantly to the improvement of euroland's international competitiveness and employment (+1.3% y/y in Q3), its economic growth and the shrinking output gap; it is much easier than before to raise prices and wages.
28. And there is **significant inflation pressure in the pipeline**: both import prices and producer prices have increased at annualized rates of close to 6 percent in the past six months. In Germany, over the half year to December 2016, seasonally adjusted consumer prices ex energy have increased at a rate of no less than 1.9 percent! In addition, the full effects of easy monetary policies and the depreciation of the euro are still to be felt, while fiscal policies across the euro area have become not only less restrictive but slightly expansionary.
29. Moreover, **the Bundesbank and the ECB have nearly always followed the Fed** which remains the world's trend setter. The time lag has rarely been more than one year. The Fed will continue to raise the Funds rate in 2017 (market expectations: from 0.66% now to 1.4% by year end) given full employment, an inflation rate of almost 2 percent and the likely fiscal stimulus of the new administration.
30. **The euro exchange rate will therefore remain under pressure in the near term and fall to less than parity against the dollar.** This will certainly be regarded as currency manipulation by the US and provoke some policy response. An even stronger dollar would make it almost impossible to achieve the doubling of the American growth rate which Trump had promised – foreign trade would be a significant drag on overall demand.



31. Also, **from a euro area perspective, a further depreciation of the euro is not necessary anymore**; the present exchange rate is already fully compatible with a further increase of inflation and an acceleration of growth. Moreover, strong fundamentals will surely lead at some point to a major appreciation of the euro, so it would be a wrong strategy to let it depreciate more in order to improve the currency union's international competitiveness: the advantage will only be temporary. And it is costly - because it leads to a wasteful allocation of labor and capital.
32. Means what? **The ECB will discontinue its easy policies sometime in the second or third quarter, no matter what has been said in public statements.** Bond markets are anticipating this already. As any central bank, the ECB is data-driven and will thus adjust policies when the reality turns out to be different from earlier expectations.
33. Mine is **certainly not the consensus view.** Analysts are still impressed by unemployment that refuses to decline more rapidly (it has recently reached 9.8%); especially youth unemployment of around 20 percent is a big worry. They can also point out that headline inflation, at 1.1% y/y in December, is still a long way from the ECB's target of 1.8 or 1.9 percent.

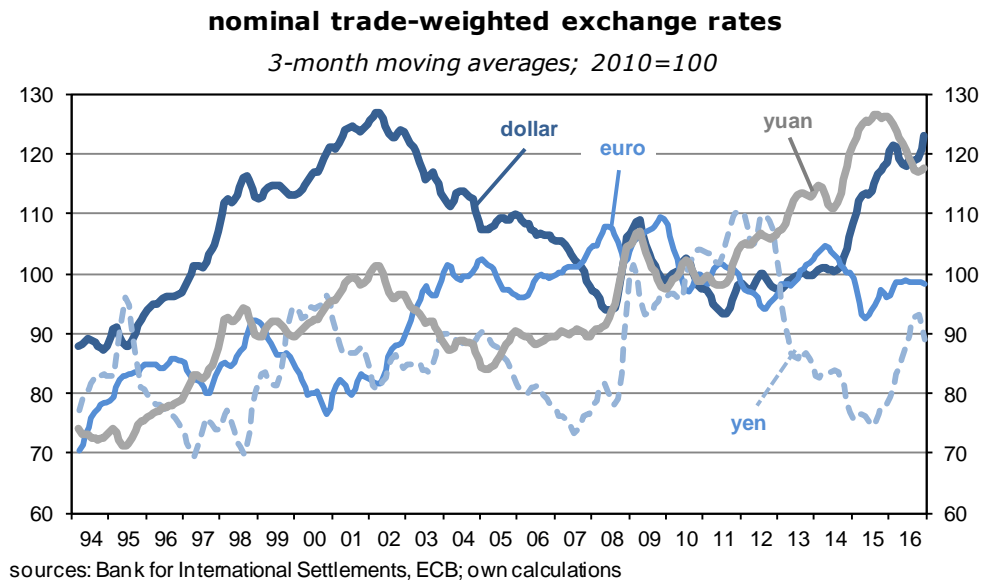
Why higher rates are the right medicine

34. **Monetary policies have been supportive of the economic recovery and the pick-up of inflation in the euro area - but they have reached their limit.** At the zero lower bound of interest rates they are simply not very effective any more. For labor market progress in particular different instruments are needed such as retraining programs, mobility support, child care facilities, subsidies for firms which hire young unemployed people, but also fiscal policies. The US has shown that the combination of easy monetary and fiscal policies can bring about full employment and rising inflation rates. To be sure, there is no guarantee that it will work in the euro area. Japan is the counterexample that comes to mind.

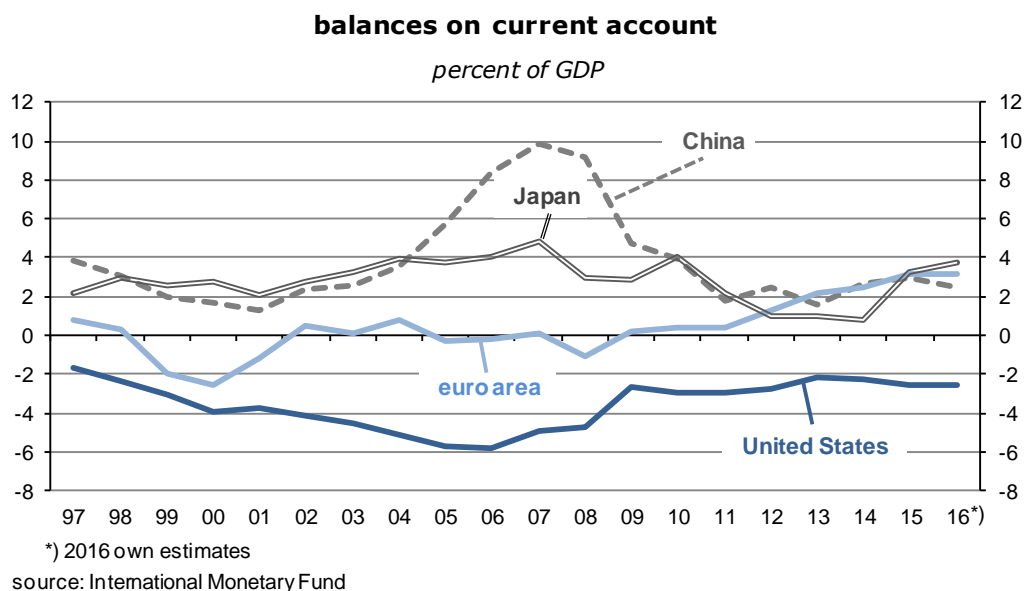
35. **For at least three reasons a rate hike by the ECB this summer is probably quite beneficial:** (1) potential investors who need external funds have to hurry up and borrow and spend as rates go up; (2) banks and insurers can expect higher profits which helps them to strengthen their balance sheets - this reduces the risk of a new crisis in the financial sector; and (3) governments have an incentive to increase the duration of their debt which in turn leads to fewer redemption events and thus contributes to financial stability.
36. The prospect of being stuck at zero interest rates forever might also sap energy from the economy and reduce productivity growth in a process of self-fulfilling prophesy – the catchwords in this context are **hysteresis and secular stagnation**. Keeping expectations of higher rates alive is therefore good in itself.
37. **Moreover, the supply of central bank money will remain generous for several quarters while real rates will rise only gradually – it will take quite some time before monetary conditions are so tight that they start to bite. I think we can look at the US for guidance in this respect.**
38. It will be interesting to watch the ECB come around to such views.
39. A stream of strong economic data, together with higher-than-expected inflation rates and, perhaps, a weak euro would bring forward the monetary policy shift. How about it?
40. So far, forecasts of euro area real GDP growth in 2017 and 2018 are rather downbeat: the OECD, for instance, expects plus 1.6 percent this year and 1.7 percent in 2018. Analysts at investment bank Barclays have arrived at 1.2 and 1.6 percent (they put too much emphasis on the effects of Brexit on the euro area). Chances are that these predictions are too pessimistic. The year 2016 has ended on a positive note, with elevated sentiment indicators, a buoyant order intake in manufacturing and the construction industry – and a notable acceleration of inflation. **The competitive euro, low interest rates, an increasing fiscal stimulus and rather large employment gains have created a favorable environment for consumption and investment. I would not be surprised if the aggregated GDP expanded at a rate of 2 percent this year.**

The euro exchange rate: near the lower turning point

41. **What is the likely trajectory of the euro?** Against the dollar it seems that the end of the depreciation is near. The main drivers have recently been expectations of a widening short-term interest rate differential in favor of the US. Since the ECB is generally not seen to change course yet, while the Fed has announced two or three hikes, this driver will dominate foreign exchange markets for several months. As mentioned above, parity between euro and dollar is not unlikely.
42. On the other hand, an even stronger dollar will not be in the interest of the Trump administration. The Fed is therefore perhaps not too keen to move quickly and aggressively. Fiscal policies may become expansionary, but the effects will show only in 2018 – it takes time to push the new spending plans through Congress. 2018 is also the year when Janet Yellen is up for re-appointment as chair of the Fed – without the support of the President she won't make it. These are convincing **reasons for US central bankers to drag their feet.**



43. Keep in mind that foreign exchange traders and analysts have been very negative about the euro and the euro area in general. It probably means that **institutional market participants are sitting on large long dollar/short euro positions**. The longer a certain opinion prevails the larger will be the following correction. It adds to the likelihood of such a scenario that the weakness of the euro occurred against a background of at least two improving fundamentals – a balance on current account which went from deficit to surplus (to probably 3½ percent of GDP in 2016), and a rapid reduction of aggregated government budget deficits (to less than 1.8 percent of GDP). This is in stark contrast to what has taken place in the US.



44. **The euro may still reach parity in the near term**, but on the basis of fundamentals and rising policy rates it will **then rebound and make up the losses it has experienced since mid-2014, ie, reach \$1.40 again**. To be sure, all this is based on the key assumption that the upcoming elections in Holland, France, Italy (?) and Germany will not produce anti-euro governments. In that case all bets are off.

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