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## Asset allocation in a goldilocks world economy

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1. Investors are running out of alternatives and are increasingly willing to disregard risk in order to get a decent return on their money. **One market after another looks decidedly overpriced**, be it Japanese bonds, US housing or Treasuries, Russian stocks, emerging market bonds, energy, metals, paintings or, perhaps, the dollar. **Is there anything cheap left?** A lot of liquidity, mostly generated by the US current account deficit, FX interventions by emerging economies' central banks and accommodative monetary policies made possible by unusually low wage inflation, is chasing a limited supply of assets. We are confronted with bubbles in many asset classes. How will this end, and what can investors do?
2. **As in Japan during the eighties, the world economy has a goldilocks feel to it, if only in terms of macro-economic indicators.** World output growth is running at a rate of 3 ½% when actual exchange rates are used to calculate GDP weights for the various national economies, and more like 4 ½% when purchasing power parities are applied (which gives countries such as China, India and Brazil larger shares). Growth in this order of magnitude has characterized the world economy since 2002.
3. This has pushed the unemployment rate down to about 6%. Employment has expanded faster than the world's labour force, but not by much. The elasticity of labour supply is still high because hundreds of millions of workers in agriculture and state-owned firms are only waiting to migrate to better-paying jobs which benefit from globalization. Competition for jobs is intense at almost all levels of qualification which implies that **wage growth is, and will remain, moderate for the foreseeable future.**
4. This is probably the main reason why **global consumer price inflation is a mere 2.7% y/y** at this point. Considering that energy prices have exploded over the past couple of years and that the Balassa-Samuelson effect would argue for rising, not falling inflation rates as developing economies gain in relative importance, this is an impressive result, and one important feature of the goldilocks environment. One side effect of low inflation has been accommodative monetary policies, of course
5. Moreover, with the exception of commodities and energy, there are **very few bottlenecks in production so far, a factor which has also contributed to low inflation.** Capital spending, the mirror image of the world's savings glut, seems to be buoyant and has boosted productivity growth, potential GDP growth and profits, even though a large share of the world's savings has been channelled into US housing, a not very productive use of funds.

6. The brisk expansion of the supply side is one thing, overinvestment is another. Too much capital spending will inevitably drive down expected returns. When these fall below the cost of financing or the returns of alternative investments such as cash, asset prices will come down. They may even crash, depending on how exaggerated previous earnings expectations and asset prices had been. **Bubbles can inflate by more and for longer than seems reasonable, but burst they will eventually.** It happens when return expectations lose touch with reality.
7. In the three major economies, the euro area, the US and Japan, central **banks are convinced that output gaps have been shrinking recently.** While this is probably true, on a strictly national level, for the US, it is less true for Japan where the steep decline of labour force participation rates over the past decade and the very high investment ratio suggest that there must be lots of unused capacities - in spite of robust GDP growth last year these have barely shrunk. Yet, the Bank of Japan is obviously determined to tighten the reins as quickly as possible. In the euro area, output gaps have actually widened until recently and it borders on the incomprehensible that the ECB has begun to raise rates with the aim to “normalize” them, just on the basis of some favourable leading indicators, while the economic expansion continues to lack momentum.
8. As it is, **European and American short-term interest rates are on the rise.** In three months’ time, the Fed Funds rate will probably be at 5% or 5¼%, and the ECB’s refinancing rate at 2¾%. The cost of funding is going up in these two economies. To put this into perspective, real rates on the basis of core consumer price inflation will then be about 2½% in the US, and 1½% in the euro area; using a different yardstick, one can compare nominal policy rates with the most recent year-over-year rates of growth of nominal GDP – these are 6.4% for the US and 3.4% for the euro area. In other words, nominal interest rates will not be particularly restrictive but the trend is clearly toward the reduction of monetary accommodation. For Europe, the policy shift is coming too early.
9. **In Japan, last week’s announcement by the BoJ that quantitative easing is ending does not mean an early end to zero policy rates** (incidentally, it also does not mean that the bank will stop underwriting long-term government bonds to the tune of 1.2 tr yen = €8.6bn a month). The new target of money market operations is the uncollateralized overnight call rate which will be kept in the zero to 0.1% range. Consumer price inflation is now slightly positive on a year-on-year basis which means real interest rates have finally become negative and thus marginally stimulative. It is not a foregone conclusion that the fight against deflation has been won: the GDP deflator, for instance, is still -1.6% y/y, and unit labour costs are falling. The disappearance of special factors after April and base revisions of the consumer price index this summer will probably keep inflation very close to zero for the rest of the year. Yet, with real GDP growth in the order of 3½% y/y in 2006 and the economy apparently firing on all cylinders, it has finally become only a matter of time that inflation will be back for good. The BoJ now officially aims for a 0 to 2% inflation range. Goldilocks in Japan as well.
10. **Rising short-term rates in the US and Europe and, in the case of Japan, the prospect of higher interest rates, plus strong or accelerating economic growth have pushed up long-term bond yields in all three economies.**
11. The increase has been smallest in Japan. A yield of just 1.68% for 10-year JGBs is an indication that investors are not really afraid of an accelerating loss of purchasing power, in spite of an import price inflation rate of no less than 25.0% y/y. **The yen exchange rate has**

**been falling in both nominal and real terms for a long while and has become a strong candidate for appreciation**, given that Japan's current account surplus is the equivalent of 3½% of GDP and by far the world's largest in absolute terms (Germany's is 3.9% of GDP, but the euro area as a whole reports a small deficit). At some point this summer or fall the Fed will stop raising interest rates while the BoJ moves closer to a rate hike. This will probably mark the turning point for the yen. Japan will then begin to import price stability rather than inflation. **The inflation outlook is therefore good and low nominal bond yields are not a sign to sell JGBs. There is no bubble that is about to burst.**

12. American bond yields have risen most and have now reached 4.78% in the ten years. It would be surprising if they stopped at this level. In spite of the strength of the economy the government budget deficit has reached 3.7% of GDP and will thus increase quite a bit once growth starts to slow (in the near term, growth will actually accelerate). The US is very dependent on capital imports and has to offer attractive terms to foreign investors. Fed policies can be interpreted in this light, and rising bond yields are also part of the picture. Foreigners have already huge holdings of dollars. In order to overcome their resistance to add to those holdings, to convince them that the so-called concentration risk is acceptable and that the dollar exchange rate is well-supported, assets, including bonds, have to become cheaper. The January trade deficit of no less than \$68.5bn, or 6.5% of GDP, shows that external imbalances continue to grow and that **the US bond market is a fairly risky place. Still, most of the necessary yield adjustment is probably behind us, and a further 50 to 100 basis point increase this year should do. There are no signs of a new outbreak of inflation mentality. Wage inflation, in particular, is well-contained.**
13. **Euro bond yields, at 3.69%, have moved almost in tandem with Treasury yields. The spread has not changed much. It shows that investors are either sceptical about inflation, or very upbeat about growth, or sceptical about the euro exchange rate.**
14. **As to inflation, they may be too impressed by what the ECB is saying.** Core inflation was just 1.2% y/y in January even though the euro's real exchange rate has continuously depreciated for more than one year. The labour market remains depressed, as do wages, disposable household incomes and private consumption. If the following assumptions prove to be correct - that the euro weakness will end sometime over the next six months, that labour unions will continue to lack bargaining power, and that energy prices will move either sideways or down from here -, it is **hard to see where inflation should come from.**
15. To be sure, **growth is now more robust**, but it is driven by export orders and, to a much lesser extent, capital spending. Lacking a solid domestic foundation, it can easily be thrown off-course by a currency appreciation or a slowdown of world trade. Growth forecasts have recently been revised up because of strong incoming orders and positive results of business sentiment surveys, but capacity ceilings are still very far away. In the early stages, faster economic growth will show up in accelerated productivity growth, not in rising prices. In the early stages of a recovery firms can improve their profits by going for volume or market share, ie scale effects and thus lower average cost levels.
16. **Scepticism about the euro exchange rate is to some extent justified.** The euro area's current account is in slight deficit, and the new outbreak of nationalistic industrial policies will discourage corporate takeovers by foreigners as well as direct investment from abroad in general. Politicians are shocked by the negative labour market effects of globalization and tend to look for populist solutions. Keep in mind, though, that continental equities have always traded with a discount to Anglo-Saxon ones because shareholder power has traditionally been

more limited. In reality, structural change is still in full swing, if mostly on the company level, and listed as well as unlisted equities remain relatively cheap. There are no signs of capital flight.

17. **To sum up, it is difficult to make the case for yet another significant increase of euro area government bond yields. In view of the sound fundamentals I would rather bet on a flattening of the yield curve, driven by higher rates at the short end, and on a widening of the Treasury-Bund spread.**
18. **One bubble that will probably be pricked by rising interest rates is US housing.** European house prices have also increased rapidly – about 7% annually in the past four years -, but the strength in demand has mostly reflected the structural adjustment to permanently lower real interest rates in the Mediterranean countries, France and Ireland following the introduction of the euro. It is not unlikely that the US housing boom has also some structural causes such as the rapid growth of the number of households and the high income elasticity of the demand for residential property. Of at least equal importance, however, has been home buyers' response to temporary factors such as low real short and long-term dollar interest rates, the rapid growth of disposable income and the favourable labour market situation.
19. **Since mid-2000, housing starts have risen from 1.5 mn a year to 2.08 mn (past 12 months through January), or at an average annual rate of 6.1%, much faster than real GDP or real disposable income.** Home building is at about the same level as during the seventies when bricks and mortar were considered the best inflation hedge - except that today, with wage inflation less than half as high, such a motive does not play much of a role. While house price inflation had been a fairly modest 5½% to 8% over the first four years of the current decade, it has accelerated to 12.0% and 13.0% in 2004 and 2005. For the average buyer, affordability looks still ok but the index reflecting this has been on a steeply falling trend since the spring of 2004. **The combination of double-digit house price inflation and rising interest rates will make home purchases overly expensive for most people at some point in the second half of this year. An early indication of what is in store is the recent decline of second home prices.**
20. The main impact will be on consumer wealth and confidence. The appreciation of an important real asset such as residential property can no longer be taken as a substitute for saving from current income. **US consumers will have to tighten their belts. How much is a question of the extent of the house price adjustment.** In a favourable case, the rate of inflation simply falls from 12% in Q4 of last year to perhaps 2 to 5% - this has been the British experience recently. Even then, the negative impact on household consumption and GDP growth will be significant. In case of a genuine housing crash a recession would be a distinct possibility. **In any case, the Fed will be forced to stop raising rates when this happens and start thinking about cutting them.**
21. **One corollary of this is a weaker dollar.** Its depreciation helps to lower the relative prices of American domestic products, compared to imported goods and services, it boosts US exports and reduces the dependency on capital inflows. The depreciation can be orderly, or it can get out of hand. Considering the amount of dollars in non-US portfolios and the size of the US current account deficit, a violent adjustment of the world's major exchange rates is more than just an outside possibility. Since the euro is the main alternative to the dollar, it will appreciate significantly.

- 22. On the other hand, the real depreciation of the yen has been much stronger than that of the euro** since the beginning of 2005, and the Japanese rate hiking process will only be at its beginning in the second half of 2006. Together with the likely end of the popular yen carry trades this argues for a new period of yen strength – I expect that the yen will even appreciate against the euro. **The Chinese currency will depreciate along with the US dollar** but since the competitiveness vis-à-vis Japan will automatically improve this way, it is conceivable that the authorities will allow a more rapid, if **controlled appreciation of the renminbi against the dollar**.
- 23. The beneficiaries of the weaker dollar will be US equities.** One has to distinguish between sectors, though. In general, exporters should be in favour, and stocks which depend on domestic demand will suffer. How about valuations and the price history? Stocks in the S&P 500, for instance, trade at a trailing price to earnings multiple of 17.8 which is considerably above the historical average and represents a risk premium of just 3.3 percentage points which means those 500 stocks are generously priced. The market is not bubbly, though, because the index is still 15% below its highs reached a little over six years ago. On this basis, the **NASDAQ index looks actually more attractive**: it is trading 51% below its highs. Investors may be scared by a multiple of 35, but earnings growth remains dynamic and will get an additional boost from a weaker dollar.
- 24. How will Japanese equities do in an environment of rising interest rates and a stronger yen?** The broad TOPIX index is still trading 42% below its end of 1989 high which does not do justice to the health of corporate balance sheets and the excellent competitiveness of all firms which are exposed to international trade. Competitiveness will deteriorate later this year if I am right about the exchange rate but it seems that the safety cushion in the present exchange rate of 119 yen to the dollar is so large that firms will be able to withstand a significant appreciation. Even at 100, life will be fairly easy for them. Asia remains the world's boom region, and Japan has the right product mix to participate. Investors also need not worry much about the rapid increase of the index – 113% over the past three years -, nor about rising interest rates. There are no signs that these may become prohibitively high any time soon. The main, but probably remote risk is that the yen appreciates excessively. Recall that it had been trading in the neighbourhood of 80 to the dollar eleven years ago. A comparable level today would be around 60.
- 25. Continental European stock markets have been rallying since spring 2003.** The broad Euro Stoxx has gained 99.6% since then (34% since the beginning of 2005) but remains 19.4% below its February 2000 peak. The risk premium is a healthy 4½ percentage points. Cheap or expensive? So far, the environment is benign but if the interest and exchange rate scenario unfolds the way I foresee it will get chillier.
- 26. One hope is certainly that the ECB will not overdo the tightening if domestic demand does not catch on during 2006.** Higher interest rates are counterproductive. The likely recovery of the euro also means that the area will begin to import price stability which could then lead to positive surprises in import prices and headline inflation. This will provide Mr. Trichet and his colleagues with some room for manoeuvre, ie allow them to go slow on rate hikes. Corporate earnings will probably continue to grow faster than nominal GDP because there are no signs yet that the income distribution will be reversed in favour of labour again. **Going by factory orders and sentiment surveys, business is quite confident that 2006 will be another good year.**

27. **Commodity markets had been the main beneficiaries of the hunt for performance last year. The Russian RTSI\$ index, for instance, is up 125% since the beginning of 2005.** The underlying story has been quite convincing: strong growth of world industrial production, undervaluation of reserves in the ground, and convergence with more developed markets. In addition, these economies benefited from the improved ratings which came with the unprecedented increase of their foreign currency reserves, the flip side of the US deficits, which made them good credit risks and independent of the IMF and other western creditors. They have in effect become net capital exporters to the rest of the world.
28. **Since markets trade on news and changes in expectations, they are presently probably not impressed by predictions that world growth and demand for energy and metals will remain buoyant – this is good but old news.** Besides, a lot of good news has been discounted already. Keep in mind that the US-dollar metals index has shot up vertically since last December and now stands 188% above its late 2001 low. Metals is old economy. So are oil and gas. Since the beginning of 2004, the CRB US energy futures index has gained 94%, and 371% from its early 1999 low. The long-term trend of relative prices is down, a trend that has only temporarily been interrupted by the fact that large emerging markets have discovered the secrets of open trade, direct investment and fast economic growth.
29. **Even so, it is hard to deny that there has been a lot of exuberance recently, most characteristically demonstrated by brokers who are busy revising up their target prices whenever an old one has been broken.** I am a strong believer in the relative price mechanism: if oil, gas, nickel, copper, platinum or whatever get very expensive, exploration goes up, marginal fields become attractive, supply rises; on the other hand, demand declines because these things have become less affordable and because substitutes will be used. This does not mean that stock markets such as Russia, South Africa, Australia or Brazil are in for a crash. A significant correction and then a pause are more likely. Selective stock picking is the order of the day from here on.
30. **The fundamentals for the commodity producers are still quite sound** as long as China, India and other key economies keep powering ahead. The slowdown of the US could yet throw a spanner into the well-oiled machine of the world economy. However, its dependence on the American consumer, 5% of the world population, is gradually declining, so a US recession does no longer automatically mean disaster for everybody else. Admittedly, this may be wishful thinking.
31. **I also do not foresee financial crises in emerging markets** – so far, their reserves keep growing at an annual rate of more than 15% which makes them unusually solvent and able to weather some storms. Incidentally, this is also the reason why emerging bond markets have suffered much less than previously from the increase in Treasury and Bund yields. They have become independent of their former creditors. Could be that they turn out to be good places to park funds during the present correction phase.