

Dieter Wermuth

Wermuth Asset Management GmbH

60329 Frankfurt am Main, Mainzer Landstrasse 47
Phone -49-69-95 92 54 85 , Fax -49-69-95 92 54 86
E-mail: dwermuth@wermutham.com

Euro area growth picks up as oil prices hit record highs

April 25, 2006

- 1. So far, the strong increase of oil, gas and metals prices has been shrugged off by European business**, mostly because the significant deterioration of the terms of trade and the loss of purchasing power which this represents has been at the expense of consumers and workers, not corporate earnings. The political climate is very much pro-business these days because the media and the economics profession have convinced the public that international competition is so fierce that domestic jobs can only be preserved if corporate profits are allowed to rise much faster than labor income. This has been the case for four years in a row and will probably be the main theme in coming years as well.
- 2. Business confidence is riding high in the euro area.** This morning's Ifo business climate indicator has, contrary to market expectations, increased once again, to a level that would suggest that German real GDP could be growing at a rate between 3% and 4%, which is clearly beyond consensus forecasts of 1.5% to 2.5%. Last time the Ifo had been as high was during the post-unification boom of 1991. It is significantly higher than in 1999 and 2000 when GDP expanded at an average rate of 2.6%. In the euro area as a whole, business is not as bullish, but sentiment is improving rapidly as well. The EU Commission's Business Climate Indicator is on a solid upward trend that has begun at the end of 2001, even though it is still some way below the level reached in 2000, its last peak.
- 3. For a change, the German economy is in better shape than the rest of the euro area.** It is not only that real exports are increasing at a rate of around 7% this year, there are also signs that domestic demand is finally picking up. This is in spite of the negative oil price effect, the on-going decline of employment and the fall in real disposable income. In January and February, real retail sales which had long been depressed, exceeded their year-ago levels by 1.1%, and their fourth quarter average by 1.4%. They seem to gain momentum.
- 4. The other problem area, the construction sector, is also finally showing signs of life after it had declined for more than a decade.** If we take the average of January and February in order to adjust for unusual weather conditions, real orders to housing were up 6.9% y/y; construction orders from business had increased by 16.1% y/y, and civil engineering orders, mostly from the public sector, by 7.5% y/y. All countries with a superior growth performance in recent years had been characterized by strong building activity which in turn has stimulated private consumption. Germany may be joining the club now. House prices, after all, have stagnated for many years, household savings rates of between 9 and 11% over the past decade have been high by international standards, and mortgage rates remain low from a historical perspective, all of which makes buying a home an attractive proposition.

5. **With industrial production very strong (6.4% y/y and 1.0% m/m in February)** - though not yet as strong as real factory orders (10.6% y/y in January) -, employment and working hours falling, and hourly wages only 1.4% higher than one year ago, unit labor costs are on a steep downward trend, by about 5% y/y. At the same time, industrial output prices are up – in March, headline inflation was 5.9% y/y, PPI ex energy was 1.2%. This means that in spite of import costs rising by 5.5% y/y, **at least in industry profits continue to increase at high double-digit rates.** Last weekend's wage settlement for the metal-using industries has not materially changed the outlook.
6. **In the other 70% of the euroland economy things are not so positive, but they are improving as well.** House price inflation averages about 9% y/y and thus stimulates private consumption, as in the years before. On the other hand, exports are less of a support than in Germany because at 3.0% y/y wages have been rising much faster, while industrial output and thus productivity growth have been slower. Germany has the world's largest trade surplus (€158bn over the past 12 months), but euroland as a whole has a surplus of only €8.3bn. Recently, monthly trade surpluses have actually turned into rapidly rising deficits as import prices outpace export prices by a large margin. In real terms, net exports continue to support GDP growth, though.
7. Since new orders to euro area industry have exceeded their year-ago levels by 8.7% over the three months through January, or by about 5.2% in volume terms, **one can be cautiously optimistic about euroland GDP growth over the remainder of the year.** Soft data, ie business and consumer surveys have also been on a rising trend for about one year now.
8. **The two main risks to the fairly benign scenario above are the energy price explosion and the exchange rate.** It is by no means a foregone conclusion that consumers will remain unimpressed by the loss of purchasing power caused by higher oil prices. It is not just that driving has become considerably more expensive, heating oil, gas and electricity prices are bound to go up a lot as well, sometimes with a time lag of up to one year. Public transportation, package tours or oil-based plastic products will also become more expensive. Generally, if prices of one category of goods such as energy which has a low price elasticity increase, the demand for other goods and services will fall.
9. **One happy circumstance so far has been the fact that key emerging economies are financially sound,** partly because they have accumulated reserves by intervening in support of the dollar, partly because they are benefiting from energy exports. The revenues from oil exports are not stashed away to the same extent as in earlier episodes of strongly rising oil prices. So the loss of consumer purchasing power in the oil importing countries is made up by exports to the new engines of the world economy, the large emerging markets of Asia, Eastern Europe and Latin America. World trade booms.
10. **Things could deteriorate if the main imbalance of the world economy, the US current account deficit, begins to unwind.** This would have two major effects: the dollar depreciates and US interest rates rise. Both will make exporting to the US more difficult, and US exports will become more competitive, not only because of the lower dollar but also because of the reduction of capacity utilization rates. A major support for the world economy would then break away.

11. **So far, this seems a remote risk, but the larger the imbalance gets the larger will be the collateral damage caused by the unwinding process.** Optimists point out that the correction is already under way as the Fed pushes back US domestic demand by raising interest rates. This is indeed the case, but, for one, the Fed has signaled that it won't tighten much more, which means rates will remain accommodative, and secondly, higher interest rates hold up the dollar exchange rate. Put differently, the income effect will reduce the trade deficit while the price effect in form of an overvalued dollar tends to increase it. Not much of a progress on the imbalance so far, nor for the foreseeable future.
12. **In this environment, the ECB will tread cautiously. While rates will certainly not be raised at the May 4 meeting, they will be raised on June 8 (to 2.75%).** Improving news from the real economy, an increase of headline inflation to 2.4% y/y in April suggested by today's statistics for Germany, together with rapid growth of M3 and equity and real estate inflation argue for a gradual tightening of the monetary reins. The ECB does not want to rock the boat, though. If the euro should appreciate too rapidly, which would increase the risk of a world currency crisis, the central bank will reconsider its plans to tighten.
13. **By year-end, the European refinancing rate will probably be at 3%, and it may then stay there for several quarters.** Note that core consumer price inflation is only 1.4% y/y, and that the rising euro and the huge increase of the German value added tax next January pose considerable risks to the economic expansion which so far has only slowly gained traction. It is by no means self-sustained yet.
14. **For European bonds, the news is not good near-term, and I have to revise up my prediction that 10-year Bund yields would peak at 4%.** Yields are driven up by higher-than-expected headline inflation, the risk that oil prices might push it up even more, the still robust expansion of the US economy, fairly positive news from the euro area, including stronger demand for housing in Germany, and the tightening processes by the Fed and the ECB.
15. **Investors are also shifting funds into equities** which are, as mentioned, well-supported by buoyant corporate earnings growth. Even on the basis of a trailing price to earnings ratio of the stocks in the DJ EuroStoxx 50 - 13.6 at this point - the earnings yield is no less than 7.3%. Deducting a real riskless long-term interest rates from this gives a risk premium of 5.4% which is quite generous. (The corresponding number for the American S&P 500 is 3%.)
16. **Under the assumption that headline inflation will at some point fall back to where core inflation is today, a Bund yield of 4% is rather attractive,** given that the main risks are on the disinflation side. The strengthening euro will be one factor that will bring down inflation, just as the likely end of the breakneck expansion of the world economy caused by monetary tightening, record-high oil prices and the inevitable slow-down of US import demand.