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How the latest statistics have changed the market outlook

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The clearest message from recent statistics is that the risk of inflation has significantly declined. They have therefore been very good news for bond markets, and yields have dropped correspondingly. Beyond this pretty straightforward observation, things are not so easy. The main questions are: How much will the US slow? And at which level will oil prices bottom out? Let's give it a try.

To recall:

Oil prices have fallen by 22% from their peak: The de-escalation of tensions in the Near East has led to a substantial reduction of the risk premium. At the same time, the demand for oil has somewhat weakened for economic reasons which has also contributed to the price decline.

In the US, inflation news has been surprisingly good. Headline CPI inflation was 3.6% annualized over the past three months, and year-on-year it has come down from its June peak of 4.3% to 3.8% in August. In September, due to the fall in import prices and a favorable base effect, it could well reach 2.6% y/y. It is not entirely riskless, though, to bet on lower inflation because core inflation is still at 2.8% y/y. On the other hand, core producer prices, the best indicators of pipeline inflation, have reassuringly fallen to 0.9% y/y and -0.4% m/m in August.

Also in the US, there has been more evidence that the housing market is in a major correction. Starts were 1.665 mn annualized in August which puts them 26.5% below the recent peak in January - they have thus declined at an annualized rate of 41% this year. All housing market indicators are pointing down, including house price inflation. Rising property prices have been the main reason why consumers had long thought they could afford not to save. They now have to adjust, mainly by tightening their belts.

In Q2, euro area GDP had been up at an annualized rate of 3.6%, after 3.2% in Q1. These were the highest rates for several years. Incoming orders to manufacturing, up 8.5% y/y in April to June, as well as the recent 5½-year high of the EU Business Climate Indicator suggest that the momentum can be maintained for a while. In Germany, the construction industry is finally recovering after a decade-long slump: The volume of orders to housing has increased by 6.8% y/y in the May to July period which is unusually good news because housing has been a strong drag on final demand, ie GDP growth, for a very long time.

Meanwhile, **euroland's inflation and cost trends remain subdued.** Headline inflation has fallen a little from a high of 2.5% to 2.3% y/y in September, ex energy and seasonal food the rate was only 1.4%. Labor cost inflation has been about as high as consumer price inflation, implying that real hourly wages have roughly been unchanged. Given the fairly strong increase in labor productivity it is a safe bet that corporate earnings are still rising briskly.

Other important developments concern **China: The renminbi has begun to revalue at a faster pace, which tends to cool the economy,** but there is no evidence yet that the appreciation exceeds inflation differentials vis-à-vis trading partners by a significant margin. Industrial production is not accelerating any longer, it seems. At August's 15.7% y/y, however, it is still racing ahead at a blistering pace, if not at the average rate of around 18% registered in the six months before. Real retail sales are in the order of 12.3% y/y (which is the ratio of a nominal growth rate of 13.8% and a 1.3% y/y inflation rate of consumer prices). China's growth is not only very rapid but also well-balanced so far. The risk of a recession is small even if the US should increase its imports at a slower rate from here on. The main risk going forward are overcapacities in housing and the exporting industries, followed by the risk that US imports collapse in the wake of a weaker dollar and a significant slow-down of GDP growth.

While the outlook for inflation has indeed improved, actual inflation at the consumer level remains higher than central banks like. This is especially true for the US where both headline and core inflation rates are "uncomfortably" high from the Fed's point of view. Unit labor costs have actually been rising at an annualized rate of 4.9% in Q2. The last thing Mr Bernanke wants to do at this point is to send a signal to the market that a rate cut is imminent. **In order to make saving more attractive for consumers and to cool domestic demand, interest rates must remain high for a while.**

This is also crucial for a gradual, as opposed to a violent correction of the world's current account imbalances. An early reduction of the Funds rate, or expectations that this will happen, could trigger a dollar crash - investors would be disappointed by the inability of the US administration to restrain demand. Since the economy is already operating at maximum capacity, the prospect of faster wage, and slower productivity growth which this implies means that corporate earnings and therefore stock markets would not have much upside potential any more. Capital inflows would not be easy to attract in such an environment.

My best bet is therefore that the Fed will leave rates unchanged for at least half a year and accept that real GDP expands at less than its potential rate. The housing market would continue to weaken, just as household spending. In combination with a softer dollar this results in stronger exports and weaker imports and a gradual reduction of the trade deficit. This in turn is positive for the inflation outlook and dollar bonds. The yield curve would invert even more.

Since the US consumes almost a quarter of the world's energy, the more moderate growth of American demand for oil makes it **unlikely that oil prices will quickly return to the record highs they had reached in August. But it is equally unlikely that the bottom will fall out from under them.**

The main reason is that **the economic weight of the rest of the world has significantly increased over the past decade** - according to the new IMF Outlook, the "rest" now accounts for 79.9% of world GDP (at purchasing power parities). So even if the US grows at rates of only 1½% between now and the end of 2007, this would result in a reduction of overall world growth from the original forecast of 4.9% y/y to approximately 4.6% next year, assuming that the non-US world will expand at 5.4%, as forecast by the IMF. This is still a very robust rate of growth which exceeds the likely annual increase in oil output of 1 ½ to 2% significantly.

It is never easy to predict when a well-established trend, in this case the steady decline of oil prices, will come to an end. The war-related risk premium has by now virtually disappeared as new hostilities in the Near East have become less likely. The question is how many investors who have financed their oil exposure with borrowed money are forced to square their positions. If this takes place on a major scale, the oil price may fall by another 10 dollars. Hard to say. Note that the lower oil prices are boosting real incomes of oil consumers, as well as the demand for oil, so there is a natural limit to their decline. **Since we are still upbeat about the world economy it seems a fairly safe bet that by now we have seen most of that decline.**

Recent statistics will not stop the ECB from raising rates in October and December.

Euroland's money supply and credit still expand quite briskly, headline inflation is embarrassingly high (2.3%), and the economy may be on the way to self-sustained growth, helped by lower oil prices, a competitive exchange rate and an increase of world trade by almost 10% in volume terms. The output gap is shrinking (but remains wide). The ECB leaves no room for doubt that rates will reach 3½% by year-end.

The longer the euro stays where it is, the likelier is it that the present growth momentum can be maintained. The coming shock to German consumers caused by the VAT increase from 16 to 19% in January and the loss of purchasing power caused by this will largely be compensated by the new strength of the housing market and the likely end of energy price inflation. **The favorable growth environment does not imply that Europe's inflation will go up from here.** Wage inflation is just 2 to 2 ½% y/y and productivity seems to rise in the order of 2 ½ to 3% y/y, so unit labor costs are falling slightly or stagnating.

The outlook for inflation could not be better. 10-year Bund yields have room to fall toward 3.5%. A further decline is not so likely because the ECB may not stop raising rates once the 3 ½% mark has been reached. If the economy permits, rates will move toward the neutral level which is in the neighborhood of 4%. It is also likely that wage inflation will begin to accelerate sometime next year. Investors will then demand a higher risk premium. In other words, the previous lows in yield will not be reached again, but a slightly inverted yield curve is a distinct possibility.

For European stocks the tightening of monetary reins is only mildly negative. Stagnating unit labor costs, a competitive exchange rate, relatively low valuations and a product mix which allows firms to participate fully in Asia's and Eastern Europe's economic boom argue for further gains in stock prices. Stock indices are still significantly below their early-2000 levels. In addition, investors have a reasonable chance that they will gain on the currency front as well.

So where do I see the euro in a year from now? In my benign mainline scenario above where the Fed does not cut rates for at least half a year, the euro will gradually appreciate to \$1.40. This would leave Europe's economic recovery intact. Life will become somewhat more difficult, but the main effect would be a gradual shift from a reliance on export demand to domestic demand, something that is long overdue. In real terms, net exports would decline while capital spending, including residential building, and household consumption would fill the gap. Europe would in this way contribute to a reduction of risks to the stability of the world economy, risks that keep central bankers awake at night these days.

A rebound of the yen against the dollar would be part of the picture as Japan's economy is super-competitive by now and benefits more than any other from the economic boom that is taking place next door. Rates will not be raised any more this year, because the risk of deflation still exists, but if present GDP trends continue, the ongoing reduction of the output gap will lead to higher wage settlements and inflation and in this way create some room for higher rates. The euro will continue to appreciate against the yen, though, because for the foreseeable future the ECB can afford to tighten more aggressively than its Japanese counterpart. **The yen will reach 110 to the dollar a year from now.**

It could appreciate more if the Chinese authorities decide that they can afford a larger appreciation of the renminbi against the dollar, something everybody continues to propose. A stronger exchange rate tends to boost real disposable incomes and thus general welfare. There is room for this because domestic demand is so strong by now that it is not necessary any more to rely so much on export-driven growth. Japan and China are competing for the world's largest current account surplus, and China's currency reserves are close to one trillion dollars. They are earning much lower interest than could be achieved by investments in China itself where productivity growth is in the order of 10% y/y.

Having said this, there are no signs that China will accept a freely floating exchange rate because this would almost certainly cause havoc in FX markets – everybody would try to buy Chinese assets because the catching-up potential of the country and the size of the market are second to none, except for India which is even further behind OECD living standards. **An appreciation of the renminbi to 7.50 to the dollar by the end of next year, from 7.9240 today, is a distinct possibility, though. In the wake of this, the yen would be pushed toward 100 to 105.**

The main risk in the benign overall scenario described above is that the Fed cuts rates too early and too much as the US economy cools faster and more dangerously than expected. In such a case, the dollar will fall well beyond the 1.40 level to the euro, and 105 to the yen. Investors have to be long European and even Japanese bonds should events move in this direction. US export stocks would benefit while European and Japanese exporters are likely to suffer.