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Investment Outlook

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1. **Is this the lull before the storm, as JPMorgan has just asked?** Volatility has once again declined and reached new lows. Investors, in their almost desperate search for attractive yields and with a lot of liquidity at their disposal, have also driven credit spreads down to levels that suggest that the risk of holding Bunds or US Treasuries is seen to be only marginally higher than that of corporate or emerging market bonds. The boom in take-over activity and mergers& acquisitions, the flood of money channeled through private equity funds just as sky-rocketing earnings of investment bankers are other signs that financial markets are about to lose, or have already lost touch with the real economy. Leverage has reached worrying proportions.

2. **Investors are facing a tough choice**: Should they gradually shift into assets which are low-yielding but fairly riskless such as money market instruments, high-dividend stocks or neglected real estate? Or should they try to make money by hooking onto the various well-established trends in commodities, currencies, equities, yield spreads, while making sure they keep tight stop-losses (even though these are not worth much in a genuine market collapse)? They can argue that there are usually fewer bubbles that will burst with a big bang than cautious analysts tend to expect. Some bubbles are in reality adjustments to structural changes in demand and supply, caused, for instance, by lower real interest rates, a scarcity of land, or changes in the institutional framework. Besides, no one can make money by being on the cautious side all the time. Another alternative, of course, is to go short the assets whose prices are clearly out of line.

3. **World liquidity, defined as the sum of OECD central bank balance sheets plus emerging markets' foreign currency reserves, seems to be still growing at double-digit rates.** The interventions in support of the dollar are the flip side of the large US current account deficit that does not seem to go away – as long as policy makers succeed in preventing a US recession and/or a bigger depreciation of the dollar. Another source of liquidity is petrodollars: Oil exporters have gained greatly in recent years and cannot increase their spending on goods and services as fast as their revenues increase. By default, they are net savers and thus forced to acquire assets.

4. Since expected returns on assets have fallen as these have become more expensive, **performance can often only be boosted by increasing leverage and by reducing the required quality standards, or both.** Banks are falling over each other to lend to hedge funds and, most dramatically in recent months, to private equity funds, some of which now have the fire power to take over the world's largest companies.

5. Since it is so **easy to pass on credit risks and to repackage and sell loan books**, banks have increasingly turned into brokers whose main, supposedly riskless income is fees from such deals, rather than interest income. It is very hard to determine how much risk there is and who actually bears it when the dominoes start falling.

6. **Credit standards have been reduced** in the process, in a development that resembles what we have seen in the US housing market. The amounts involved are even larger, and the risks more unfathomable – this time, the arena is not a well-defined if large regional market but the world economy as a whole.

7. To provide some flavor of what is going on in the markets for selling and buying over-the-counter risks, let me quote a passage from yesterday's BIS report on "OTC derivatives market activity in the second half of 2006". In notional terms, the so-called **credit default swaps** (CDSs) had reached $29tr at the end of last year, or about 50% of the world's GDP, and $470bn in terms of gross market values which "measure the cost of replacing all existing contracts and thus represent a better measure of risk at any point in time."

8. **The BIS comes to the following conclusion:** "Activity in the CDS market was in part driven by issuance of synthetic collateralized debt obligations (CDOs) and other structured products that use CDSs to obtain credit exposure. The impact of such issuance on positions in the CDS market could be considerably larger than suggested by nominal amounts, since hedging structured credit products may involve selling a multiple of their face value, in particular in case of more junior tranches whose prices are very sensitive to market conditions. The multiples of more complex products, such as constant proportion portfolio insurance (CPPI) and constant proportion debt obligations (CPDOs), may be even higher. That said, it is impossible to disentangle the effect of structured issuance on CDS volumes from other factors." (p. 2)

9. To different degrees, **policies of the key central banks are still expansionary and contribute to the sense that the risks of loading up on assets are limited.** One yardstick that can be used to verify this statement is the difference between nominal GDP growth and policy rates. Some examples: In the US it is 4.8% y/y and 5.3% saar versus a Fed funds rate of 5.25%, in the euro area 5.0% y/y vs. 3.75%, in Japan 1.8% y/y vs. 0.5%, in China 14.9% vs. 6.57%, in India 14.4% y/y vs. 7.75%, in Brazil 8.8% y/y vs. 12.5%, and in Russia 26.8% y/y vs. 10.5%. Since inflation is mostly well contained while real GDP growth is buoyant, central banks don't want to spoil the parties – and thus in effect provide a variant of what has come to be known as the Greenspan put.

10. **As it is, asset price inflation will be with us for the foreseeable future**. In the end, though, some or most of the economic imbalances need to be corrected which – in a worst case scenario - could be followed by a systemic crisis. In the benign outcome there could also be a gradual unwinding. In both cases, though, I would expect deflationary effects.

11. **Surplus liquidity could also move, in the traditional pattern, into accelerated consumer purchases of goods and services and thus drive up CPI** rather than the prices of homes or stocks or commodities. High asset prices would actually be a supportive factor in such a process because they make saving less of a necessity. The assets do the saving for their owners who can therefore keep on spending. The liquidity/CPI link has virtually disappeared in recent years. While the Fed has drawn the conclusion that it will not publish monetary aggregates any longer, other central banks, the ECB in particular, are worried that this is owed to today's confluence of

unique developments and that the link will re-appear in due time – in other words, CPI inflation is not dead, just sleeping.

12. **One of the reasons why consumer price inflation is not affected by the flood of liquidity so far is the persistent weakness of workers' negotiating power** which has resulted in unusually low wage inflation. This probably reflects the surplus supply of cheap (Asian) labor which, in the increasingly integrated global economy, is putting downward pressure on wages everywhere. Other than in similar instances in the past, labor has therefore been unable to defend itself against the loss of purchasing power caused by the recent tripling of oil prices.

13. **Low wage inflation could also reflect a low level of capacity utilization** – but this is not a particularly convincing argument when world output growth has been near 5% for such a long time. In spite of the worldwide investment boom capacity ceilings must be near. So, to the contrary, we should actually expect labor costs to start accelerating pretty soon, which could trigger a wage/consumer price inflation spiral after all. The question is: when?

14. While this is a possibility, it is certainly not priced in by markets. Inflation expectations, derived from yield curves, surveys of analysts or so-called inflation linkers, are slightly rising but remain subdued. Moreover, actual consumer price inflation in developed markets is presently only 1.7% y/y, and 4.2% in emerging markets. That is as close as one can get to price stability. Investors are thus little worried about the risk that central banks might kill off the boom; they keep spending their funds happily on assets that, by most measures, would be considered to be overvalued by now.

15. **Should bubbles in some of the equity, real estate, commodity and low-quality credit markets burst at some point, the net effect would be deflationary, not inflationary.** As the corrections of the US and Spanish housing markets show, even a fairly gentle asset price deflation has a positive impact on inflation. Government bonds of European, American and Japanese issuers may not be particularly attractive near-term investments – as forecasts for US and world economic growth are revised up -, they will be regarded as safe haven investments in case the world economy is hit by a more serious demand shock.

16. **Such a shock can be triggered by a re-appraisal of risks and a simultaneous collapse of several asset markets.** The fact that in spite of the advanced stage of the business cycle both dollar and euro bond yields are presently below what I would regard as their "neutral" levels – in the 10-year range these are 4.9% to 5.3% for US Treasuries, and around 4½% for euro area government bonds – can be interpreted as a sign that many investors are hedging their bets already. In a similar vein: The rapid increase of credit default swaps could mean that banks are increasingly concerned about the quality of their assets, and are buying insurance against the risks of defaults.

17. **In the meantime, world economic growth continues apace. The main drivers are the emerging markets** of Asia, Eastern Europe, the Near East and Latin America. Most of them are financially sound because they have current account surpluses and/or are net receivers of private capital. The IMF has totally lost its leverage over these countries and can thus not force them to tighten their monetary and fiscal reins. One effect of letting growth "rip" is a rapid increase of capital spending and productivity – modern machines, equipment and software allow phenomenal efficiency gains as companies often move from pre-industrial methods of production straight into the cyber age. Unit labor costs are therefore either falling or rising very moderately; this translates into strong corporate earnings growth.

18. **In the case of China, the positive outlook for profits has contributed to the extraordinary stock market rally which begins to resemble Japan's bubble of the eighties.** However, other than in Japan at the time, real estate prices have not gone through the roof (about 6% y/y at the moment). It seems that housing and office supply has been rising very fast, about in step with demand. But the stock market has clearly gotten out of hand, driven by generous borrowing conditions and plenty of liquidity. The number of retail share accounts is doubling every few months, and speculating on the stock market has become the main game in town. While this looks very dangerous, a decade-long recession cum deflation as in Japan that could follow once the bubble bursts can probably be avoided as the government is likely to recapitalize the banking sector fairly quickly. It certainly has the financial means.

19. **A crash in China - and in other parts of emerging Asia where things have been equally bubbly - will have severe effects on commodity prices**, even if it is quickly followed by a rebound. In recent years, this group of countries has generated most of the world's marginal demand for energy and metals and is therefore the region to watch for those who invest in commodities or shares in commodity-rich countries such as Russia, Mexico, South Africa, Brazil, Australia or Canada. Should the economies of the Asian countries slow significantly, the commodity boom would probably collapse. Any recovery would depend crucially on a rebound of growth in Asia as well.

20. **So here we have a link that could be truly dangerous**: a stock market crash in emerging Asia, reduced growth expectations there, a collapse of energy and other commodity prices, knock-on effects on commodity-dependent markets, including a reduction of capital inflows and currency depreciations, a flight to safety, ie government bonds. How serious the impact on the financial stability and the real economy will be depends on the financial prowess of the affected countries and the extent to which their economies have been able to emancipate themselves from the ups and downs of commodity prices. The longer the present situation lasts, the larger will be their financial reserves and the role of domestic demand.

21. **Russia is a good example** for what I have in mind. Foreign currency reserves are now at close to $400bn, and the transition from export to domestic demand-driven growth is steadily proceeding. Housing, infrastructure, retail, logistics, financial services and air travel are all booming - which puts the economy on an increasingly sure footing. Moreover, given its budget surpluses, the government has the means to support demand in case export revenues decline a lot. Russia's economy is probably quite resilient by now.

22. **How about the mother of the world's imbalances, the US savings shortfall and its most visible expression, the 6%-of-GDP current account deficit, the major source of liquidity in other countries?** The deficit will not easily go away as long as dollar assets appear to be relatively cheap and/or safe, and as long as the administration succeeds in preventing a recession or significantly slower growth. For the time-being, we are in an unstable equilibrium, and markets confidently extrapolate this stability. Investors may be hesitating, but they are still buying American IOUs on a grand scale after all. These consist mostly of fixed income instruments rather than real assets. The issue that, as a result, their so-called concentration risk is increasing, has faded into the background again. Alan Greenspan once worried about that.

23. **The likelihood of a major realignment of currencies is small as long as the US economy appears to be on the road to recovery again** – because it means the Fed can keep interest rates on a fairly high level while the corporate earnings outlook will not deteriorate as fast as expected, or actually improve again. For now, this is the dominant view. But the longer the US remains addicted to foreign savings, the more unstable the situation will get. In other words, an early end to the dollar depreciation and the economic slow-down in the US is bad news for the long-term stability of the world financial system.

24. **It is a fairly safe bet that the yen and the renminbi are the most undervalued of the major currencies,** judging by the current account surpluses and the robust rates of economic growth. What is the opposite of an asset bubble? Since the two currencies are so cheap, the current account surpluses of Japan and China will almost inevitably continue to rise, even though they have already reached 4% and 8% of GDP. Holding the exchange rates down through low interest rates and interventions only pushes forward the day of reckoning. In the longer run, interest instruments denominated in renminbi and yen wait to be discovered because the coming appreciations will have major deflationary effects. In spite of their yield of only 1.6%, yen bonds with 10-year maturities are thus not necessarily overvalued.

25. **At risk in a future general deflation of asset prices are obviously the yield spreads** of corporate bonds and bonds of those emerging markets which are at the receiving end of high commodity prices. Spreads are at record lows and do not reflect actual risks, in particular the risk of default and of rising volatility in a general realignment of relative prices, including exchange rates.

26. **To conclude: Asset prices must keep in touch with expected returns**, ie the flows of income they can generate – if these change, for instance because interest rates are being raised, or because there is an oversupply which pushes down selling prices or rents, or because the income distribution shifts in favor of wages, asset prices must change as well. The more elevated these are, and the larger the degree of leverage, the more violent will be the adjustment.

27. I wonder what investors can really learn from the brief tour d'horizon above. The message is that there are lots of risks, some of them obvious, others not well understood, and the outcome could be terrible. We knew this beforehand. For the time being, things look fine and I cannot tell how long this lasts. The trend is your friend. Perhaps I have raised the awareness for the triggers which could set in motion a chain reaction in asset markets, and that some buy-and-hold strategies are dangerous in a world characterized by so many imbalances.