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## Investment Outlook

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1. **It is no longer a question whether the US will experience a recession, but rather how long and deep it will be and how it will affect the rest of the world.** America's weight in terms of GDP has declined over time but is still very large. The mirror image of America's rapid improvement of its real balance of trade - which results from slower economic growth and a weak exchange rate - is the deterioration of net exports in the rest of the world. America's gains in foreign trade support its growth rate, but they reduce growth in other countries.
2. **An equally important linkage is through capital markets: if US stock markets decline in the wake of the coming 10 to 20% fall in corporate profits, it is likely that other stock markets will be negatively affected as well** – as US portfolio managers take profits on their foreign assets. The rising cost of issuing equity will reduce capital spending and thus GDP growth everywhere. Another channel is via securitized money markets which have de facto been closed down.
3. While the major effect on the world economy originates from the US, **record high energy prices as well as the recent spike in food prices have been a blow to household disposable incomes in other countries as well.** The oil price hike from 30 to 92 dollars a barrel between 2003 and today has resulted in an additional annual income transfer of almost 2 trillion dollars from the consumers to the producers of oil. To put this into perspective, world GDP at current exchange rates is about 50 trillion dollars. The oil price increase is certainly not trivial and can not simply be shrugged off.
4. Not surprisingly, forecasts by central banks, international organizations, research institutes and investment banks continue to be revised down. The **United Nations economists, for instance, put the average 2008 growth rate for real world GDP at 3.4% y/y, but in their alternative risk scenario they arrive at only 1.6%, a lower rate than anybody can remember.** Since emerging economies, which account for between one third and one half of global output, depending on the weighting method, are still expanding briskly, the implication is that the OECD area will more or less stagnate this year.
5. Inflation is high compared to where it was only one year ago. **Headline rates are actually still mostly on the rise, but it is clear that they will soon peak, as demand weakens.** The coming environment is not inflationary but deflationary. Inflation is a lagging indicator which reflects the past rather than expectations of things to come.

6. To be sure, going by the gold price, which has hit an all-time high a few days ago, **deflation is not yet market consensus**. I think there is an inconsistency between rich countries' falling stock markets, strong government bond markets and monetary easing by some key central banks on the one hand and rising prices of precious metals on the other hand. The outlook can not be for deflation and inflation at the same time.
7. **The US economy (nom. GDP: €9.6tr) is in a situation which resembles Japan's at the end of the eighties**. The long expansion had been based on accommodative, even expansionary monetary policies and a resulting boom of stock and house prices. Investors were led to believe that the Fed would always try to prevent a recession and a decline of asset prices, a phenomenon known as the Greenspan put. Asset prices were therefore seen to be well supported and to be moving around a strong upward trend. Market weakness was regarded as an opportunity to buy.
8. Under such conditions it made sense for banks and other companies to **borrow in order to improve returns on investment**. **Households, on the other hand, saw little risk in borrowing to the hilt for consumption purposes**. Servicing their debt was not regarded as a problem. Not only was it easy to find jobs, it was also easy to borrow fresh money from willing banks as long as the value of households' assets kept on rising. Banks were riding high on the wave of originate and distribute – they earned fees while their balance sheets were kept clean. Or so they thought.
9. Since inflation was moderate, thanks to the integration of hundreds of millions of Chinese and Indian workers into the international production process and a rapid expansion of the world's supply of goods and services, **the Fed could afford such a benign policy** without running into conflicts of interest. Huge net capital imports filled a large part of the savings gap that resulted from overconsumption. America became the miracle economy of the past 15 years, and financial engineering was a major driving force.
10. As it turned out, the **UK (nom. GDP: €1.1tr) had pursued similar finance-based economic policies**, with a reliance on rising asset prices and household spending. The country is now facing the same problems as the US: a decline of house prices and corporate profits as well as a depreciation of the exchange rate.
11. **The Fed and the Bank of England have once again begun to cut interest rates, in another effort to prevent recessions. It will not be easy to succeed**. Especially in the US, the housing market is in a free fall. Most statistics show that demand and output have declined by about 50% from their recent peaks. There has never been a case where such a crash had not been accompanied by a full-fledged general recession. Because of the oversupply of residential properties, prices will probably go down another 10 % or so.
12. **Since the value of houses had been more than 300% of US disposable income, three times more than the value of equities, such a decline will be a shock to consumers**, most of whom have never experienced house price deflation. This comes on top of the loss of wealth from a falling stock market. Since December, consumers have thus aggressively begun to tighten their belts. Their debt levels are too high relative to the present and expected value of their collateral.

13. Lower interest rates help, but this is not enough if the main problem is over-indebtedness, ie if balance sheets need to be repaired by spending less. **The Fed is pushing on a string in such a situation, just as the Bank of Japan did during the nineties.** The Bank of England will soon make the same experience.
14. **For several reasons, the outcome will probably not be as bad as it was in Japan:** the dollar has depreciated significantly for the past six years which has improved American firms' price competitiveness whereas the yen had been extremely strong during the first half of the nineties. The world economy as a whole is also in better shape than it was then, as fast-growing and financially sound emerging economies have become major players. International trade will remain buoyant. Last but not least, both fiscal and monetary policies will react promptly to the risk of recession – Americans have learned from Japan's mistakes.
15. **The US recession - which began in December – will last at least until the middle of this year.** The average duration of recessions has been ten months. The Fed will aggressively reduce the Funds rate. Markets are predicting a further series of cuts, from presently 4.25% to 3% by June. **Dollar money markets** will thus become increasingly less attractive. On the other hand, falling short-term rates will support **government bonds**; 10-year Treasury yields seem to be moving toward 3%. The outlook for **equities**, especially those which depend on domestic demand, is negative as the reduction of corporate profits continues in response to weak final demand. Since the US current account deficit is still 5% of GDP, the overall demand for dollars will therefore be rather weak for some more months. **The dollar** depreciation has not yet ended.
16. **Investments in the euro area (nom. GDP: €8.9tr)** will do better than dollar investments, if only in relative terms. At the last ECB meeting on January 10 the discussion was whether interest rates should be raised or left unchanged. So far the hard data on the area's real economy do not suggest that there is an imminent risk of a recession; industrial production was 3.8% y/y, incoming orders were 7.9% y/y, and employment is expanding at a rate of more than 1½% y/y. At the same time, consumer price inflation, at 3.1% y/y in December, is way above the target of "just below 2%".
17. **GDP growth this year will be less than in 2007, when it averaged 2.7% on a year-on-year basis.** Current forecasts call for something like 2% which is not bad considering Europeans' moderate ambitions. Nominal GDP growth will probably be between 3½% and 4% y/y.
18. **The risk of a recession is still small because the euro area does not suffer much from the deflation of house price bubbles and bank assets** that is hurting the US and the UK. The Spanish and Irish real estate booms were even more exaggerated than those in the US and Britain, but the weight of these two countries in euro area GDP is just 10%. Moreover, the aggregated household savings rate of the 15-country region has been in the order of 10% which is an indication that household balance sheets are quite sound. The financial situation of business is very robust in any case, after many years of excellent earnings and cautious capital spending.

19. Yet, going by recent statements of board members, I have the impression that the **ECB is now beginning to worry about the real economy after all**. Financial problems in the financial sector are simply not going away, and the strong euro and high commodity prices could start to take their toll. It is increasingly unlikely that the ECB will raise interest rates. A cut is more likely, but it will require a string of low monthly increases of headline inflation – 0.2% or less, seasonally adjusted – and a deterioration of labor market statistics. I assume that the main refinancing rate will be reduced in May or June at the earliest.
20. **Such a prospect is good for euro area government bonds. They have underperformed US Treasuries by a wide margin last year**, in spite of the relatively more positive inflation outlook caused by the euro appreciation. It is also clear that, as dollar interest rates start to fall below euro rates later this month, the interest rate differential will drive up the euro against the dollar. \$1.60 per euro is now within reach.
21. It is likely that **corporate profits will once again increase, but by less than last year** when the combination of fast growth and subdued wage increases had pushed up earnings per share by around 20% y/y. Euro area wage inflation will accelerate somewhat this year, perhaps to 3% y/y, from 2.3% y/y in 2007. The non-labor share in national income will therefore rise once again, but not nearly as strongly as in the past. Domestic demand growth will not make up for the reduction of net exports.
22. **The currency of the month is the yen**. It keeps appreciating not only against dollar and sterling but also against the euro. Falling asset prices in formerly high-yielding markets are ringing alarm bells in Japan (nom. GDP: €3.3tr). The country is a large net capital exporter, together with China, Germany, OPEC and Russia. One strategy that had been popular for a long time had been the so-called carry trades where purchases of non-Japanese assets were funded by borrowing cheap yen. These deals quickly lose their attractiveness when the value of foreign assets falls and, more importantly, is expected to fall further. So the trades are presently being unwound which puts an enormous upward pressure on the yen exchange rate.
23. **Deflation will therefore remain the Damocles sword hanging over Japan's economy**; the GDP deflator had been minus 0.4% y/y in Q3, and 10-year government bond yields are just 1.39% (they are nevertheless quite attractive given that the yen appreciation has so much momentum). In the past years, Japan's industry had benefited a lot from the real depreciation of the yen against the currencies of its trading partners, especially dollar and renminbi. This is coming to an end.
24. But keep in mind that the yen had been at 80 to the dollar in spring 1995 already. Considering how much lower Japanese inflation has been in the intervening years, this would probably be the equivalent of 60 yen to the dollar today. A long way to go from today's 107.5! The Ministry of Finance will not allow such an exchange rate, though. Expect **interventions in case the yen approaches 100 to the dollar. Since this would boost domestic liquidity and demand, it would support Japanese stocks which are surprisingly cheap these days and certainly worth a closer look. International competitiveness is second to none.**

25. **China (nom. GDP: €2.2tr) remains the fastest growing of the major economies**, and the main contributor to commodity price inflation. In purchasing power parity terms it has a much larger weight in world GDP than those 6.4% which one gets if current exchange rates are used. The International Monetary Fund arrives at a weight of 15.1%, the World Bank at 9.7%. In Q3 real GDP was 11.5% y/y, and nominal GDP 17.3% y/y. Translated into US dollars, growth has been well above 20%.
26. So far, such blistering growth rates have only led to a fairly mild **acceleration of inflation, to 6.9% y/y**. Much of that is the result of higher oil and food prices and does not reflect fundamental inflation problems. Since capital spending is more than 40% of total spending, capacity constraints are no serious problem yet. Supply keeps pace with demand.
27. **On balance, Chinese monetary policy is expansionary, if increasingly less so**. The main driving forces are exchange market interventions aimed at preventing a stronger appreciation of the renminbi, and interest rates which are well below the growth rate of nominal GDP. The People's Bank of China has permitted an appreciation against the dollar at an annualized rate of about 15% over the past three months, and it keeps increasing the minimum reserve ratio, but as long as the 1-year working capital lending rate, which is the main official interest rate, is just 7.47% one can only conclude that a high growth rate rather than low inflation has priority. A "neutral" interest rate should be in the order of 17 to 18%.
28. One effect of these extremely expansionary monetary policies has been what can only be called a **stock market bubble. The average trailing price-to-earnings ratios on the Shanghai market is no less than 47**. This is not as high as Japan's p/e ratio just before the day of reckoning in early 1990, but it is moving there. Other parallels with Japan are the construction boom and the currency appreciation. This means that the risk of a crash is rising, and that China's powerful support for world growth and commodity prices will not last forever.
29. Keep in mind that there is also something like **overinvestment**, too much of a good thing. The classical 19<sup>th</sup> century business cycles were caused by this. At some point, the expected returns on new investments fall below the cost of finance which sets in motion a downward spiral. As usual, bubbles last longer than analysts think, but in the end they will burst, by definition. Always.
30. **Commodity prices have probably peaked for now** as world economic growth is set to slow. They have increased three to seven times faster than world nominal GDP over the past four years. Only in case of a new political crisis in a sensitive region will they take off again. It is unlikely that we will see a full-blown commodity price crash as long as expectations are that the slowdown of world GDP growth will be fairly brief and shallow. Could be that this is just wishful thinking.
31. The other **triggers to watch are China's economy and stock markets**. If they perform much worse than presently expected, the main – and last - support for commodities will be withdrawn. Aside from this, commodity prices also have natural upper limits which result from substitution, more production and less demand, at least in the medium term. Market forces do work. In other words, it is less risky to be short than long commodities at this point.

32. **Finally, a word about Russia**, the main producer and exporter of commodities. The latest foreign trade and currency reserve statistics show that the terms of trade have improved once again: export prices have been rising much faster than import prices. As a result of FX market intervention aimed at keeping the rouble down, money supply has been rising as fast as ever, by more than 50% from one year ago. This is more than twice as fast as China's and a main reason for the construction boom – in terms of square meters, residential construction is up 19.3% y/y -, the stock market rally in the second half of last year, plus the steep increase in consumer price inflation, to 11.9% y/y in December.
33. **Hourly wages have been rising by no less than 28% y/y**. So people who have a job do not complain, and those without one do not have a voice. They also benefit from subsidized housing, heating, education, transportation and, to some extent, food. Russia's real GDP has been expanding at a rate of about 7½% annually this decade, and **full employment has de facto been achieved**: the employment rate is 48.6%, about the same as in Germany, and unemployment is just 5.9%. Even so, nominal GDP per capita is still only one fifth that of the euro area.
34. **The driver of growth is not industrial production – which suffers from the wage explosion in combination with a firm exchange rate – but domestic demand**, ie housing, banking, infrastructure, electricity, retail trade, telecommunication, transportation, all sorts of other services and agriculture. Growth rates of extraction industries are generally fairly low, mostly because of physical constraints. On the other hand, manufacturing industries which are in one way or another protected against international competition or which have installed state-of-the-art facilities are doing quite well. It is not all bad in industry.
35. **The main risk for investors in Russian equities is a large decline of commodity prices**, perhaps in the wake of slower global growth. Predictable results would be a quick deterioration of the balance of trade, less FX market interventions, slower liquidity growth, and a reduction of the growth rate of real household incomes below the rate of growth of real GDP. This could cause a shock to consumers. On the other hand, the public sector has conducted fairly conservative fiscal policies and would therefore have the means to support overall demand through an increase in government spending and lower taxes. Over the past years, the Russian economy has diversified away from commodities and is now less exposed to the ups and downs of commodity prices. But it is still a long way before true independence will be achieved.
36. **To sum up:**
- **the outlook for the world economy has darkened**
  - **the United States seems to be in recession; with some luck, it will be short**
  - **but the rest of the world economy is also slowing, because of high commodity prices**
  - **policy rates are on the way down in the OECD area; even the ECB will cut**
  - **corporate earnings will not rise so fast any more; in the US they are falling**
  - **the euro area capital markets have safe haven qualities this year**
  - **yen carry trades are being unwound, making the yen the strongest currency**
  - **the depreciation of dollar and sterling has still some distance to run**
  - **in general, the environment is more deflationary than inflationary**
  - **government bond markets are generally well supported**
  - **commodity prices will be under pressure for a while**
  - **China is still roaring ahead, but there are now stock and housing market bubbles**
  - **Russia remains exposed to a decline of commodity prices but is fundamentally sound**

