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Investment Outlook

August 1, 2008

1. **Stock markets are very weak, bond markets are (or were) weak, and the global economy continues to get weaker. While headline inflation is still on the rise, the demand shock caused by the severe loss of purchasing power will soon bring it down, especially in commodity-importing countries. Oil, food and metals prices are already falling. It helps that wage inflation never really took off as workers in rich countries are increasingly exposed to international competition with low-cost labor. Unit wage costs, the main drivers of inflation in earlier episodes, have been rising only moderately, especially in the OECD region.**

2. But the negative effects on output and employment of the commodity boom that may just have ended as well as the effects of the various financial and housing crises are still working their way through the systems. On a current exchange rate basis, **world real GDP is presently growing at an annualized rate of only 1½% and thus well below the 3½% trend rate**. This leads to a widening of output gaps and thus to downward pressure on prices. There are no signs yet of a near-term bottoming-out of the global business cycle.

3. For investors, recent **large changes of relative prices of currencies, stocks, real estate, interest rate products, commodities and wages have created many opportunities**. Oil, coal, steel, copper, aluminum, gold, grains or the euro still look expensive after their multi-year run-ups whereas financials, airlines, auto companies, property developers, US or Spanish real estate, American exporters and multinationals, Chinese equities, the renminbi and other emerging market currencies, or Italian government bonds may all be cheap by now, or at least a lot cheaper than not long ago. To be sure, if prices have fallen it does not mean that they will not fall more – and vice versa. Not all significant price movements will necessarily be reversed.

4. To go into more detail, the **US economy had a surprisingly good first half of the year**, on the back of expansionary fiscal and monetary policies. Real GDP increased at an annualized rate of 1.4%. Growth was also supported by a strong improvement in foreign trade. In Q2, real imports were down 1.7% y/y, real exports were up 6.8% y/y. There are several reasons for this: the dollar is rather competitive by now, America's capacity reserves are large and rising (this leads to aggressive bidding for business in order to reduce unit costs of production), and foreign economies as a group had been growing faster than the US.

5. By now **America's cyclical advantage in foreign trade, the fact that its economy has cooled earlier than others, is gone.** The positive effects of the tax credits are also fizzling out. The weakness of domestic demand is the main factor that will shape the future.

6. Consumers were until recently faced with 4-dollars-a-gallon gasoline; unemployment continues to rise, real estate and stock prices continue to fall. Since savings rates are low, there is **almost no cushion that would allow them to maintain previous rates of spending growth**. In the meantime, home-mortgage rates are near a year high; 30-year fixed-rate mortgages which are eligible for purchase by Fannie Mae and Freddie Mac cost 6.71%, while jumbo loans are at 7.84%. The housing market will stay in the doldrums.

7. **By Q2, US corporate earnings had declined for four quarters in a row.** To be sure, earnings levels are still quite high after many years of strong profits and a significant redistribution of national income in favor of business. It is no longer just financials that are struggling. Increasing slack across the economy means tougher competition; passing on higher input costs to clients will therefore be difficult.

8. **The consensus among brokers is still that firms in the S&P 500 will be able to raise per-share earnings by 23.7% between 2008 and 2009** (according to Bloomberg page WPE, p/e('08) = 14.44 and p/e('09) = 11.69; according to the rule of three e('09) / e('08) = 14.44 / 11.69 = 1.237). Such an increase is highly unlikely as below-trend GDP growth will continue well into 2009. The brokers seem to have got the sign wrong.

9. Consumer **inflation has accelerated to 5% y/y.** This reflects the combined effects of a weak dollar and the huge increase of commodity prices. Even after the recent decline, oil prices are still up more than 70% from one year ago. Import prices overall are +20.5% y/y, producer prices +9.2% y/y. There is thus a lot of pressure in the inflation pipeline and it would not surprise if headline rates rose some more.

10. The situation is less scary than these numbers suggest because **weak domestic demand will inevitably bring down consumer price inflation.** One of the reasons is that the US is presently in a situation where national income is rising by much less than output (ie real GDP) – this is the so-called terms-of-trade effect which arises when import prices increase faster than export prices (these were 8.6%y/y). Americans are thus forced to tighten their belts, something the doctor had actually prescribed for a long time. They can no longer live beyond their means.

11. **In real terms, the improvement of the US balance of trade proceeds at an impressive rate**, but in nominal terms progress has been slow. The deficit is still about 5% of GDP and remains one of the main reasons why the dollar exchange rate will not recover easily. The OECD has calculated that the **purchasing power parity rate against the euro is about $1.16**, while the Economist's "Big Mac" exchange rate is at $1.06 – these numbers suggest that there is a huge potential for a stronger dollar. But as long as the trade flows create so much supply of dollars in foreign exchange markets, it would take a strong improvement of private capital flows to compensate for this.

12. It is not yet happening. As I have shown above, American equities trade at a p/e ratio of 14.44% which translates into an earnings yield of 6.9% (which is the inverse of 14.44). Given that real government yields in the 10-year range are around 1½% (4% minus expected inflation of 2.5%), the resulting risk premium of 5.4 percentage points is well above historical averages. By this yardstick, **US stock markets are quite attractive for investors**. **The only problem at this point is that profits will probably fall further.**

13. Even so, **two key fundamentals for a dollar rebound – real trade flows and stock market valuations - are clearly on the mend. On the negative side is still the expectation that the Fed will not be able to raise the Funds rate by more than 25 basis points** between now and the end of the year (to 2¼%), which will leave it at least 200 basis point below the ECB's main refinancing rate of (presently) 4¼%. Some analysts would not be surprised if the dollar became a funding currency in carry trades, especially if China's or Europe's central banks decide to tighten policies further.

14. It is also negative for the dollar exchange rate that **real US government bond yields are so extremely low.** Bond prices would head down as yields normalize, ie move from 4% toward something like 6% (2½% inflation target, 3% potential GDP growth, ½% volatility premium). In addition, there is still such a large overhang of dollars in the hands of foreigners, the result of 15 years of rising current account deficits, that a further near-term depreciation is more likely than an early rebound.

15. **When will the US economy recover?** It depends crucially on consumers whose spending is 72% of GDP. They have not yet begun in earnest to repair their personal balance sheets which have been hit by falling home prices (-18.4% from the peak in July 2006) as well as by a weak stock market (the S&P500 is down 19.6% from the last high in October 2007). Not only that their collateral for borrowing keeps shrinking, they also suffer from a significant negative wealth effect – they feel poorer and will tend to put more money aside for rainy days. But it is still early days.

16. **The labor market remains in fairly good shape**, at least on the basis of official statistics; from last January to July payrolls have declined at an annualized rate of just 0.6%. This is about to get worse now as lay-offs in the financial sector, the car industry, at airlines and retailers accelerate. It is therefore likely that **consumer spending will weaken**; the recent fiscal stimulus is now petering out. We will also get more negative news on corporate profits.

17. **The Fed, meanwhile, continues to pursue a very expansionary policy**, and the US administration has de facto nationalized Fannie Mae and Freddie Mac in a desperate effort to stabilize the housing sector. This helps to slow the slide, but I have no idea when it will end. Bond market yields certainly predict a very long period of sub-par growth or low inflation, or both.

18. **The economy of the euro area is now in decline.** Real GDP had increased at an annualized rate of almost 3% in the first quarter, but the onslaught of a super-strong euro, the purchasing power shock caused by high food and energy prices and the weakening of demand in the US, the UK, Sweden, Switzerland, Japan and even in Eastern Europe and other emerging markets has probably led to a slight (q/q) decline of output in the second quarter. Business and consumer surveys, incoming orders to industry, housing activity and stock markets all point steeply down; real household incomes are more or less unchanged from one year ago, but have probably declined over the past few months.

19. This comes after **17 quarters of fairly robust GDP growth – 2.3% p.a. on average – and an annual increase of employment of 1.3% during that time (to 145.7m).** For the area as a whole the government budget deficit will be a modest 0.9% of GDP this year, while the balance on current account will show either a small deficit or a small surplus. In both respects the euro area thus distinguishes itself favorably from the US and the UK which are both

running much larger deficits. Profits had been booming for a long time and the income distribution has shifted strongly in their favor, as in most other OECD countries.

20. In spite of the progress on the jobs front, the financial situation of European households has not been comfortable. It was expected to improve in 2008 so that private consumption would become an additional driver, perhaps even the main driver, of growth. As it turned out, **exploding energy and food prices have more than neutralized the effects of slightly higher wage increases.** Since the euro has been strong throughout, the discrepancy between export and import price inflation, and thus the terms-of-trade shock, has been quite a bit milder than in the US. Even so, it has still been a shock. Policy support for consumer spending has been lacking so far. The ECB has actually raised rates in early July, in an attempt to reduce inflation expectations, while governments are only now waking up to the risk that their economies are at the brink of a recession.

21. **Italian and French policy makers have put pressure on the ECB** to be less ambitious about inflation by replacing the "close to but below 2%" target by a range of 1 to 3%, to stimulate economic growth, and to enter into a more intensive dialogue with the Eurogroup of finance ministers, in other words to make it more like the Fed. At the core of this would be a change of the Maastricht Treaty. Since Germany and some smaller countries are strongly opposed to such attempts, it will not happen. Bullying may actually stiffen the ECB's back, in the old Bundesbank tradition, and makes rate increases actually more likely.

22. As it is, the **ECB will simply sit tight for months to come**. The recent fall in commodity prices plus the rapid deterioration of the region's economy have improved the odds that headline inflation will start to come down later this year. It is in any case only a large change in relative prices between commodities and other goods and services that is behind its increase to 4% y/y in June (probably the same as in July), not the outbreak of a new bout of inflation mentality. Interest rate hikes are a blunt sword for fighting the big increase of commodity prices caused by strong demand from emerging markets.

23. **Monetary conditions in the euro area are tight**: the euro has significantly appreciated in real trade-weighted terms, the government yield curve is almost flat between one and ten years (the steeper the curve, the more expansionary are policies), and the ECB's real refinancing rate is slightly positive if the actual headline inflation rate is used, and about 1¾% on the basis of inflation expectations (America's real Fed funds rate is negative on both measures). Moreover, as the ECB reports, banks have become very selective in their lending - the financial crisis is almost as serious as in the US.

24. Since economic headwinds will get stronger in coming quarters, **fiscal policies are about to ease somewhat.** The emphasis is on supporting the poor, reducing non-wage labor costs and helping, counterproductively, truckers, fishermen, commuters and other users of energy. So far the programs and proposals look limited in scope. Government budget deficits will mostly rise for cyclical reasons, perhaps a lot, as revenue growth slows and spending for social purposes increases. Automatic stabilizers will play a larger role than discretionary policy actions.

25. In the past, **rising government deficits were usually accompanied by falling bond yields.** The deficits were seen as evidence that the economy was struggling and that inflation would come down, if not immediately. 10-year Bund yields are now at 4.38% or 40 basis points higher than US Treasury yields.

26. **Investors are obviously rather upbeat about inflation prospects in the euro area.** If there were another rate hike by the ECB, it is likely that the yield curve would invert. This means that, almost no matter what happens at the short end, yields of high-quality bonds are near their peak and will decline.

27. Stocks are another matter. **The bear market is well-established and it will not end unless there are indications of an improvement of profits.** These are typically more volatile over the business cycle than wages: they had increased much faster than labor income since the beginning of this decade, and are now in reverse. This is bad news for European equities.

28. Of the three macro-economic cost components, **unit labor costs** are rising faster than before, due to lower capacity utilization rates and correspondingly slower productivity gains, **capital costs** are also up, as costs of bank and bond market funding are more or less stable while the cost of raising equity has increased steeply because stock markets are so weak, and **import costs** have exploded. Because of the strong euro and weak domestic demand, it is difficult to raise output prices sufficiently**. Profit margins will shrink, no matter that the consensus among brokers calls for a per share earnings increase of 4% y/y in 2008, and another 12% increase in 2009.**

29. Among the stocks that have been hit hardest are those of insurers and re-insurers. Compared to the peak in 2007, Allianz has lost 39%, AXA 46%, Generali 33%, Munich Re 25%, and – outside the euro area – Swiss Re 45%, Prudential (UK) 32%, and America's AIG 64%. These companies are all important and supposedly professional investors in the stock markets, yet they are faring worse than these. They may have spent too much money on toxic asset backed securities, but **their financial health remains robust – and they will thus rebound strongly once there are reliable signals that the bear market has ended.**

30. In the meantime, stocks **of euro area companies that participate in a significant way in the infrastructure and consumer booms in oil exporting emerging markets** such as Russia and the countries of the Middle East look like plausible investment alternatives.

31. **The main signal that could turn around OECD stock markets would be indications that the oil price decline will continue.** This is principally dependent on developments in China, the swing country. Between 1997 and 2007, global oil consumption rose by 11.6m barrels per day (mbpd) to 85.22 mbpd (1.5% p.a.). Of this 11.6 mbpd increase, 3.7 were accounted for by China which consumed 7.9 mbpd last year (a 10-year growth rate of 6.5% p.a.). For comparison, all of North America expanded its oil consumption by only 2.7 mbpd, the Middle East by 1.8, India by 0.9, South and Central America by 0.7. At the same time, Japan reduced its oil consumption by 0.7 mbpd, and Germany by 0.5 mbpd. Basically, all rich countries, with the exception of the US and Spain, continue to save oil.

32. **China's oil demand has lately responded to high prices.** According to the International Energy Agency, it was up only 3.0% y/y in Q2 (compared to the 6.5% trend rate); **demand has actually declined at an annualized rate of 2.2% between Q4 and Q2.** Normally, oil consumption is positively correlated with real GDP growth, and negatively with oil prices. Harm Bandholz of UniCredit has just calculated for the US that the income sensitivity of petroleum demand is twice as large as price sensitivity (1970-2007, correlation of +0.69 versus -0.33). Since something similar probably holds for the world as a whole and for China in particular, ongoing strong economic growth and falling oil prices may from now on interact to stabilize China's demand for oil and thus prevent a free fall of its world market price.

33. But **can China really power on regardless of what happens in the rest of the world?** Except for the warning signs from stock markets which have declined by 54% since their high last October (Shanghai) there are no indications that GDP growth might slow a lot, say below 6% or so. The trade surplus has shrunk by 11.4% from one year ago in the first two quarters, mostly due to the explosion of commodity prices. In real terms, it is still likely that net exports have contributed positively to overall growth (10.1% y/y in Q2). The main momentum is now in domestic demand: seasonally adjusted, retail sales were up no less than 30.1% q/q annualized in Q2 (CPI was 7.1% y/y in June), and real gross capital formation continues grow by around 15% y/y.

34. **Here is perhaps the main risk for China's economy: overinvestment.** The ratio of capital spending to GDP is in the order of 36% (which implies a national savings rate of 45%, given that the current account surplus is 9% of GDP), compared to ratios of around 20% in most OECD countries.

35. **Much of this investment is productivity-enhancing** - think of infrastructure or machinery and equipment - and thus profitable and income-generating from a macro point of view. But we know that even in these areas, there can be too much of a good thing. The marginal return of a new 4-lane highway which runs parallel to an existing one will be less than that of the original one. The same with additional labor-saving processes in manufacturing, and especially with office buildings and private homes. Once investors realize that the actual and implied costs of financing are not covered by returns that can realistically be expected from the investment projects, the music will stop. The more mature, ie capital rich the country becomes, the closer it gets to the point where investment will collapse, followed by a recession. I am not saying that China is near such a turning point, but it needs watching. Incidentally, the massive increase of energy prices may already require the scrapping of those production facilities that rely on cheap oil and coal.

36. The **economy of China's neighbor Japan – whose nominal GDP is still 55% larger** at today's exchange rate - has probably declined in Q2 compared to Q1. The weakness is comparable to that of Western Europe. While the country has been less affected by financial turmoil than the US and the euro area, growth is held back "by slower export growth, weak household incomes and some hesitancy on the part of firms to invest" (says the OECD in the editorial of the new Economic Outlook).

37. **Japan's import prices had been up no less than 17.0% y/y in June, while export prices had declined by 4.2% y/y.** This is an indication of the problems faced by business, especially **the loss of pricing power**. The ratio of producer price to consumer price inflation – 5.6% vs. 2.0% y/y in June – conveys the same message. Consumers are also in trouble these days: nominal household spending has been -1.8% y/y which translates into a decline of 3.8% in real terms. The terms of trade effect has had a strongly negative impact on domestic demand: output is declining but real household incomes are declining by even more.

38. **No wonder that oil demand has fallen at an annualized rate of 17.5% between Q4 and Q2.** The best news for Japan, and the trigger that could lead to faster growth and stronger stock markets, would be if the steep decline of dollar oil prices continued for a while. Japan's oil demand is certainly a major contributing factor to the present correction of oil markets.

39. **Is deflation now a thing of the past? I do not think so.** The headline inflation rate of 2% y/y reflects almost exclusively the steep increase of import prices which, as it looks now, is a transitory phenomenon. Since unemployment is on the rise (4.1% in June), workers are in no position to fight back. So wage hikes are very subdued.

40. Ten-year government bond yields of presently 1.53% may look rather low, but **as inflation rates come down again yields will also decline.** At some point the real and nominal devaluation of the yen will end which will provide an extra kicker for non-Japanese investors. The current account surplus, the best long-term predictor of exchange rates, is no less than 4% of GDP this year.

41. **Japanese equities have held up relatively well in 2008, but they are 28.3% below their last peak** in July 2007 and thus in a bear market. The international competitiveness of exporters has greatly improved in terms of prices, a decline of earnings has already been priced in, and the country's products are well matched with the needs of emerging markets which are presently the world's growth engines. Equities are not overpriced.

42. Finally, a look at **Russian stock markets**. They have recently been hit by a triple whammy: declining commodity prices, especially oil (-16% from the high in early July), the weakness of foreign stock markets, and scary political interferences at TNK-BP and Mechel which have caused a bad press. The RTSI$ has been in a free fall in July and is 21.7% below the peak of May 19, 2008.

43. But the **risk premium is now very high**, with an earnings yield on the basis of 2008 estimated earnings of no less than 12.3% (ie a p/e ratio of 8.1). Note that an exact calculation of the risk premium is not possible because the real riskless bond rate is not really known, or not relevant. If one deducts the inflation rate of 15.1% y/y from the Russian government's bond yield of about 6½% one gets a real yield of -7½%. Deducting this number from the earnings yield of 12.3% gives us a risk premium of close to 20 percentage points. Normally, in an OECD market, a premium of 6 would be wonderful. **For whatever this calculation is worth, the message is that the market is cheap.**

44. **What could trigger a turnaround in Russia?** It is obvious that those factors which have been responsible for the latest sell-out will also be key for a reversal. But I fear that the **oil price decline has not yet ended** as the global economy continues to slow; most metals prices are also correcting strongly. With regard to **American and European stock markets which often set the tone for Russia**, the flow of disappointing corporate news is not about to ebb. Consumers in the OECD area are still shocked by their energy-related loss of purchasing power – price increases for heating oil, gas and electricity reach them with a time lag and will mostly be felt this fall and winter. A recovery of overall demand is not yet likely; it is still going downhill. As to the strange and aggressive **behavior of the Russian government** toward big business, I cannot be sure at this point that a de-escalation is around the corner. On the other hand, experience tells me that the administration has often been capable of a quick volte-face. As long as we don't see this I suggest that it is too early to jump back into the market. But there are clearly opportunities for contrarians.