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## Investment Outlook

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1. By historical standards, lots of **assets are very cheap these days**. “Cheap assets” is not the same as “good assets”, though – prices may fall much further. Investors are in uncharted territory:
  - **Share prices** have come down so much – between 40 and 80% from their recent cyclical peaks - that they look tempting now; not only that, valuations such as price-to-earnings or price-to-book ratios have been adjusted down as well.
  - Most **commodity prices** have crashed since last summer’s peak even though they are still above their long-term trend lines; at some point they will fall below these, given the deepening global recession.
  - High-grade **government bonds** look expensive; since the industrialized countries where they are issued are rapidly approaching deflation their prices may well rise more, pushing down yields.
  - Most **corporate bonds** offer attractive yield spreads over Treasuries, Bunds and JGBs; even after this extremely deep recession most of the issuers will still be around – and in case of default creditors, ie bond holders, are better protected than shareholders.
  - **Inflation-linked bonds** have been neglected in the present environment of rapidly falling inflation rates and have become very attractive as well.
  - **The dollar** has appreciated in spite of America’s ballooning fiscal deficit, zero interest rates and a huge current account deficit. Because investors obviously expect that the US administration will handle the crisis more effectively than the policy makers of the euro area, not to speak of emerging economies, the dollar has become a safe haven rather than a borrowing currency in carry trades. But why is it that **sterling** is so weak, given that Britain’s fundamentals are comparable to America’s while the Labour government and the Bank of England are just as determined to fight recession and save the banks?
2. **The answers to these questions – whether to buy or not to buy, and what – depend on the trajectory of the world economy** and what it will do to the level and structure of output, to inflation and relative prices, to exchange rates and so on. My impression that we are in a once-in-a-lifetime recession has been confirmed this month by two American economists (**Carmen Reinhart and Ken Rogoff**, NBER Working Paper 14656). They show empirically that slumps that follow “severe financial crises ... tend to be protracted affairs.”
3. They focus on Spain 1977, Norway 1987, Finland 1991, Sweden 1991, Japan 1992, the Asian crisis of 1997-1998, Colombia 1998, Argentina 2001 as well as on two earlier cases, Norway 1899 and the United States 1929. All these financial crises are statistically well documented, including house prices.
4. **Banking crises are always triggered by, and associated with, steeply declining asset prices**. On average, the two authors find that real house prices dropped 35.5% from peak to trough, and the decline lasted roughly six years (17 years in Japan!!). Real equity prices fell by 55.9% over a period of 3.4 years.

5. **The effects on the real economy were severe:** unemployment rose 7 percentage points over an average of 4.8 years, real per capita GDP fell 9.3% peak-to-trough in just under two years, and real public debt shot up by 86% in the three years following the banking crisis.
6. These are scary numbers. Reinhart and Rogoff argue that the **present crisis is so far unfolding in a way that closely tracks historical precedent.** In addition, what is really scary today is that we are not, as in the past, confronted with a national or regional crisis but a rather a global one, under the leadership of the largest economy. No country can export its way out of its recession these days, or gain much advantage by aggressively devaluing the currency or other beggar-thy-neighbor strategies.
7. **The working assumption for investors should be that, in spite of all the efforts of central bankers and other policy makers, the turning point is still well ahead of us.** All crises end some day, but unless we get more convincing evidence from leading indicators than the occasional increase of new home sales, the Ifo-index, or commodity prices, we should avoid wishful thinking and take for a fact what we are seeing: that the world economy is in a free fall.
8. **The global recession is now in its third quarter.** It would be a benign outcome if it were indeed over in another five quarters, as suggested by Reinhart's and Rogoff's data, ie in the summer of 2010. Most forecasts have actually penciled in a recovery for the second half of 2009 already. Market participants do not agree – because if they did we would see a rush into stocks which typically rebound much earlier than the real economy. We don't.
9. **It is hard to imagine that the world economy as a whole will, in terms of real GDP, shrink by those 9.3% mentioned above** (note that this is a per-capita figure, because of population growth the overall GDP decline has been somewhat less). On the basis of actual exchange rates, trend growth is 3% per year, or 4% on the basis of purchasing power parities (fast-growing emerging economies get a larger weight in the latter).
10. In other words, if potential global real GDP grows by 6% over two years (or 8% on a PPP-basis) while actual GDP shrinks by, say, 8.5%, an output gap between potential and actual GDP of 15% or more would open up. The global unemployment rate would thus increase by at least 15 percentage points, with catastrophic consequences.
11. **Forecasts from respected institutions are getting more pessimistic by the day.** JPMorgan and Roubini see negative rates of growth for global GDP in 2009 (-1.2% and -0.4% y/y). Today we got the latest forecast from the IMF: at market rates, world GDP will still rise this year (0.5% y/y), but in PPP-terms they expect a decline by 0.6% - both numbers are 1.7 percentage points lower than last fall!
12. While this is the worst outcome since at least the Korean war, it looks manageable from a policy point of view. But as forecasters are throwing their old models on the rubbish heap of economic theories, and try to understand the effects of deleveraging, these predictions are certainly not the last word.
13. The Financial Times had a headline on its front page yesterday that said “More woe as 72,500 jobs axed in one day” by leading corporations in Europe, US and Asia. This is a reflection of the dire financial situation of business. All news on the corporate front is bad. **The reduction of costs and leverage that is now under way is perfectly sensible for each single firm, for the economy as a whole it is deadly. Policy makers are aware of that and are pulling out all stops, but probably to no avail in the near-term, if history can be taken as a guide.**

14. **In the fourth quarter, real GDP in the OECD area's four largest economies declined at annualized rates of around 6%.** The industrialized countries are thus on the way into a very deep recession. The GDP prediction can be derived in a back-of-an-envelope way from industrial production for which we have monthly data. Taking the last two available numbers and comparing them with those of six months ago yields the following annualized growth rates for industrial production: US -12.1%, euro area -10.1%, Japan -17.4%, UK -9.4%. Even in Brazil, Russia, India and China – the BRICs - industrial production is now either stagnating or shrinking.
15. Firms have held on to their staff more than could be expected when looking at these output numbers. But the watershed has probably been passed and unemployment will begin to rise steeply this quarter. In the commodity-importing countries of the OECD region there has been a sizable terms-of-trade effect since last summer which has stabilized household consumption, together with the surprisingly robust labor markets (firms had been in a state of denial about the length of the recession): household incomes kept rising while consumer prices fell. Compared to the **labor market Tsunami** that is now hitting the shores, this positive effect is no longer strong enough to prevent a decline of private consumption, the key component of overall demand.
16. It is therefore **likely that corporate earnings forecasts are too optimistic.** According to Bloomberg (code wpe <go>), per share earnings of the companies in the S&P500 will be 35% higher this year than last, and up by another 22% in 2010. The trailing price-to-earnings ratio of the index is no less than 16.5 which translates into an earnings yield of 6.06%; given a riskless real long-term interest rate of 1½% (10-year US Treasury yield minus expected inflation) the risk premium is around 4.5 percentage points, somewhat lower than the historical average. If, as I suspect, 2009 profits will be lower than those of 2008 (rather than 35% higher) we would get an even smaller risk premium. **The strong US stock market is a puzzle. Shouldn't the appreciating dollar be more negative for stocks?**
17. In **Japan**, current year earnings are expected to be 43% less than last year – which looks plausible to me. But a price/earnings ratio of 20.4 (expected 2009 earnings) suggests that stocks are not cheap. **Nowhere in the industrialized world with the exception of Spain or Ireland is the recession as deep as in Japan.** The country suffers from the strong yen, the decline of real disposable income, and the collapse of export demand while government and central bank believe they have exhausted their tool kits - expansionary policies are no longer possible. The high p/e ratio also reflects the new risk aversion of Japanese investors who once again think that home is best. No more carry trades!
18. **European stocks are relatively cheap, as always.** On a trailing basis, their earnings yield is no less than 13.3%, while the real riskless long-term interest rate is in the order 1.7%. The risk premium is thus a whopping 11½ percentage points on top of the real bond yield. Investors consider euro area assets to be rather risky, something that also has an impact on the euro exchange rate. They make a mistake.
19. Actually, there is, **among the larger stock markets, an even cheaper one: Russia's.** The country has problems with the big decline of commodity prices, corporate governance is not as good as it should, corruption is rampant, the stock market has become rather illiquid, and its belligerent and autocratic government tends to scare foreigners. Moreover, the many years when the country suffered from Dutch disease (an overvalued exchange rate caused by the commodity price boom) have left it with a non-competitive manufacturing sector. Everything sophisticated has to be imported. To add to the list of negatives, banks and other corporates have problems rolling over their foreign currency debt which, as it turns out, is much larger than expected. There is also capital flight. Foreign currency reserves are thus melting away quickly (but are still at \$396bn).

20. **The fact that the rouble has been in a free fall until a few days ago is actually a good thing because this is, of course, the remedy for the Dutch disease:** imports will be substituted by domestic production (and employment), exports will be stronger, and the country can, to some extent, wean itself off its addiction to commodity exports. Several other aspects continue to speak for Russian equities in the medium term: the country will always have something that can be sold – commodities; the internal market, with a population of 144m, is very big, living standards and the quality of the infrastructure are fairly poor and suggest a considerable long-term catch-up potential; I would also guess that US policies toward Russia will be less confrontational than under the previous administration – a more cooperative style would reassure investors.
21. **The most convincing argument at this point is low valuations: the p/e ratio for the dollar-denominated RTSI index of blue-chip stocks is just 2.9 on a trailing basis, and 4.0 on current-year earnings estimates.** I do not believe that commodity prices will rebound any time soon, but the huge risk premium of Russian stocks offers plenty of upside potential for gutsy investors. Note that on May 19 last year, the index has been at 2,488, but trades at 545 now. It may fall further, but the upside potential will increase correspondingly: the price to book ratio is just 0.5. How much worse can the situation get? Not much I would say. Lots of negative things have been priced in. Even a 100% rebound would leave stock prices at depressed levels.
22. **Commodity prices have plummeted since last summer.** But only some are really low, such as the price for aluminum which is about 15% below its medium-term trend line. Copper is roughly 45% above, oil and nickel about 15%. Food remains expensive and should become considerably cheaper as productivity gains in output continue to exceed the growth rate of demand– unless the global recession leads to a significant increase of protectionism, as during the depression of the thirties. The key aspect is that the **marginal costs of producing commodities are very low:** once the capital has been spent on production facilities, it pays to keep them running even if output prices fall below average unit costs. The usually steep supply curves imply that prices can easily collapse when demand shrinks during a deep and prolonged recession, as today. The near-term outlook for commodities is therefore bleak, and it pays to short most of them I would guess.
23. **For AAA-government bonds the key questions are whether there will indeed be deflation** and how long it will last, and what sky-rocketing public sector deficits will do to yields. If we eliminate volatile energy and seasonal food prices from consumer price indices, ie temporary effects, deflation has not yet arrived. The so-called core CPI has been stagnating over the past couple of months, but so far it has not declined (or just a little bit, such as in the US and the UK) while the headline index is now on the way down in all major economies, including China and Russia.
24. The economic **situation is deteriorating too quickly to expect a pick-up of core inflation this year or next.** Wages, the key driver on the cost side of the inflation function, will be under pressure from now on as employment shrinks significantly everywhere. Expected inflation rates will therefore fall and in their wake pull down yields.
25. That **government budget deficits are ballooning** is more a reflection of the deep recession than of overly expansionary fiscal policies. The public sector is only partially able to fill the gap in demand created by the private sector; it can do no more than reduce the pain somewhat. Ironically, the larger the deficits the more will bond yields decline. The situation would be different if the economies were roaring ahead full steam, without any capacity reserves left.
26. **Look at Japan:** the budget deficit was 3.3% of GDP last year, and will be even higher this year, yet 10-year government bond yields are just 1.25%. Such a level is probably the goal post for American and European bonds. In the 10-year range, US Treasuries yield 2.55%, German Bunds 3.26%, French OATs 3.80%, Dutch governments 4.01%. These are actually all rather solid securities.

27. Since the thrust of government stimulation packages is to save jobs, the business sector which provides those jobs will benefit. These measures are reducing the risk of bankruptcy. Investors should buy **corporate bonds issued by firms which are most likely to survive the crisis, such as utilities or well-run market leaders in strategic sectors**. Risk premia are still very generous and are probably overstating the actual danger of default. In addition, in the case of European bonds, the cost of carry is certain to decline further in coming quarters - these bonds will therefore gain even if spreads over borrowing costs do not come down.
28. **Why is the euro-dollar exchange rate so weak?** At the moment, market participants are impressed by the following: **1.** the euro area interest rate advantage vis-à-vis the US of presently almost 200 basis points will largely disappear in the course of 2009, **2.** the US balance of trade deficit is shrinking very quickly, as a result of weak GDP growth and falling commodity prices, **3.** the euro area could disintegrate; evidence of this is the huge risk premia paid by ClubMed countries over German benchmarks, and **4.** a nation state such as the US is better able to tackle an economic crisis than the heterogeneous euro area (a political eunuch, as the Russians like to point out).
29. **All this is true, but it is also true that** **1.** euro area interest rates are higher, and will remain higher, **2.** equities are considerably cheaper than in the US (and have benefited, at least relatively, from the euro depreciation), **3.** deleveraging is not such a problem for the area as a whole – because debt dynamics have been more subdued (much higher savings rate), **4.** the euro area current account deficit is still rather small compared to America's. I therefore guess that the euro depreciation has more or less run its course (I seem to have a home bias, though!).
30. Against **sterling**, the euro has appreciated by no less than 38% ( $\Rightarrow 0.93 / 0.67$ ) since August 2007 when a long period of an almost stable cross rate came to an end. Markets fear that Britain's reliance on financial services and housing is a disadvantage at a time of crashing banking and real estate markets. In spite of the huge depreciation inflation is subdued which shows the severity of the recession. Even lower interest rates and an even weaker exchange rate are therefore not only possible but probable. If Britain were a member of the European currency area, such a rescue operation would not have been possible. The alternative would have been a devastating recession. That is why the British like their pound and their independent central bank.
31. **The yen has been the strongest of the major currencies** – since the middle of 2007, the dollar has lost 28% against it, in spite of Japan's near-zero interest rates, anemic economic growth and a rapidly shrinking trade surplus. Carry trades (= capital exports) are not an almost automatic equalizer of the still impressive current account surplus any more, as interest rates in other countries are approaching Japanese levels. Since exports are collapsing, the country can not really afford such a strong currency. On the other hand, it is by no means as strong as in 1995 – to reach a comparable level, the dollar would have to fall to about 65 yen. It is 89.4 now. In any case, interventions to stop a further appreciation are getting likelier. For various reasons, it seems impossible to stimulate domestic demand enough to provide a compensation for faltering exports.
32. Finally, a word about **two east European currencies. The Russian rouble is still in a free fall.** Since the middle of last July it has depreciated by 38% against the dollar (to RUB 33.75). Russia's balance of trade is swinging from a surplus of almost 7% of GDP to a deficit of about the same magnitude within little over a year, because of the crash of commodity markets. Since the central bank cannot raise interest rates sufficiently to make speculation against the rouble more costly – because the economy is already in recession –, and does not want to introduce capital controls yet, it opts for a combination of interventions (thereby enabling Russian banks and other borrowers to service their euro and dollar debt), a widening of the intervention bands (de facto allowing a depreciation to the new lower intervention level) and the occasional rouble liquidity squeeze which makes short positions a risky matter. **An end to this fairly orderly process will be reached once commodity prices bottom out. This is not a near-term prospect.**

33. **The Polish zloty is also very weak: last summer 3.20 zloties were needed to buy one euro, today it is 4.35 zloties.** As the other formerly communist east European countries whose currencies are also depreciating, Poland had grown very rapidly during the last decade but has failed to build a diversified and therefore resilient economic structure. A significant part of capital spending (including housing) was funded in (depreciating) foreign currencies. Net capital imports were in the order of 5½% of GDP. As west European lenders have become more risk averse, they ask their money back. Rather than appreciating as in the past, the zloty is therefore depreciating which in turn increases the real debt burden for Polish borrowers (in zloty terms). Since an increase in interest rates is politically problematic – unemployment approaches 10%, a recession has begun – it is almost inevitable that the zloty will depreciate further.
34. It is obvious that **western banks are very worried about their Polish assets.** Even though Poland is not a member of the euro area, it is clear that the ECB and the European Union will come to the rescue with some bridging loans. The best would be if Poland could join the euro area and accept the discipline that this entails, but the **Maastricht Treaty** does not allow a suspension of its strict rules. If these are not changed, Poland can only hope to become a member after about three years, at the earliest. And this means it has to accept a very deep recession and to defend the currency at all costs. I doubt that this is politically an option.