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## Investment Outlook

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1. It is one of those rare occasions: **global stock and commodity markets are rising, and bond markets are rising as well.** Investors are increasingly convinced that the economic recovery is under way and that corporate earnings will improve as a result, while they are equally convinced that inflation will remain subdued for quite some time. Good growth and stable prices, what more can one ask for? How sustainable is such a benign scenario?
2. To start, for a change, with the **outlook for bond markets:** their main driver is inflation expectations. A comparison of 10-year regular and inflation-linked government bonds shows that the so-called break-even inflation rate is 1.75% in Germany and 1.88% in the US. These numbers can be seen as market-based inflation expectations. Germany's have been rather stable this year whereas America's have increased rapidly from less than 1% only a few months ago: fears of a new depression have by now given way to a more exuberant view of the business cycle.
3. Inflation expectations are, in turn, driven by the amount of excess capacity in an economy and thus by the perceived pricing power of firms. No one knows exactly how much slack there is because potential output can not be observed directly. But it is clear that the **global economy is operating far below normal.**
4. In the US, estimated potential GDP growth is in the order of 2.5% (which is already less than the standard 3.25% estimate of not long ago). Given growth rates of actual real GDP of 0.4% y/y in 2008 and a likely -2.8% y/y in 2009 means that the output gap is in the order of 7.5% of potential GDP this year. For the euro area, the corresponding figure is 7.8%, and for the world economy as a whole it is 7.3% (assuming a potential GDP growth rate of 3.8% p.a. on a purchasing power basis). **All these gaps are extraordinarily large. And they continue to rise in 2010 if consensus growth forecasts turn out to be correct.**
5. This has two important implications: in order to boost capacity utilization rates and thus profits, firms will offer their goods and services at or near (low) marginal costs. Resulting **price wars** contribute to downward pressures on inflation and may even cause deflation. Companies also try to cut costs by laying off workers, reducing their wages and shutting down parts of their operations. **Wages, the key cost component, are thus under downward pressure as well.**
6. So we are still in a situation where in spite of the rebound of the world economy **wages and consumer price inflation will remain subdued for at least another year.** Producer prices are in deeply negative territory – in other words, there is deflation in the pipeline,

not inflation. Central bank rates in the OECD area cannot, and will not, be raised in such an environment.

7. As to the **ECB**, as unemployment gets worse and inflation turns into deflation, it is becoming likelier that it will join the crowd and give up its resistance against zero interest rates: in June, headline euro area PPI was -6.6% y/y, and PPI ex energy was -3.5%. I would **not be surprised if the main refinancing rate dropped to 0.25% by next spring**, from 1.0% today. If this happens, the deposit rate on excess reserves at the ECB might be set at -0.5%. Sweden, where the deposit rate has already reached -0.25%, may be the role model for such a policy shift.
8. **Negative interest rates are an attractive alternative to quantitative easing** – they are not difficult to reverse when monetary reins have to be tightened again. Relying on them means avoiding the tricky issue of who should recapitalize the ECB in case of losses caused by defaults on low-quality assets. The main stumbling block in the way of introducing negative interest rates is currency in circulation - at some point holding cash under the mattress would be the best game in town, the best protection against deflation. We talk about €734bn which may have to be taken out of the system, especially the large-denomination bills so popular in black market transactions.
9. Incidentally, **China is also in the grip of deflation. It** reflects the fact that potential output is still growing at double-digit rates - capital spending accounts for more than one half of total spending!– while output expands by several percentage points less. The People's Bank of China desperately tries to stimulate domestic demand as a compensation for the steep decline of exports. Social tensions caused by rising unemployment are a serious risk for the government. It does not quite work: M2 is up almost 30% from one year ago, and new yuan-denominated loans by almost 40%, but much of this growth ends up in the stock market where a new bubble has developed, and in commodity prices which by now look decidedly bubbly as well.
10. China pursues the same policies that have contributed to the global credit boom that has now burst. By not letting the renminbi appreciate, ie by buying dollars, liquidity is ample but domestic demand remains artificially suppressed. It is the opposite of what the country needs. It is called beggar-thy-neighbour policies.
11. To return to the main theme: **major bond markets are well supported by extremely low costs of carry, whereas other markets, especially in emerging economies, are supported by falling inflation rates and improving inflation expectations.** The simultaneous flooding of interbank markets with liquidity has finally **reduced risk aversion** as measured, for instance, by the spread between 3-month LIBOR and 3-month government debt. The spread has reached 30 basis points in the US, 51 bp in the UK, 56 bp in Germany, and 30 bp in Japan. To be sure, we are by no means back to the days when these spreads used to be miniscule, when banks were regarded as almost as solid as governments, but the financial crisis looks less threatening at this point.
12. **Bond markets would be even stronger were it not for the rapid increase of government budget deficits.** Investors fear that one day all that easily available liquidity will be used to inflate away the debt mountains. This explains why long-term US Treasuries underperform Bunds. America's budget deficits appear to be out of control relative to euro area developments. The reliance on quantitative easing, and thus the printing press, is significantly more aggressive. The spread trade "long Bunds / short

Treasuries” will continue to do well. I guess that it will even work for shorter maturities now (because the ECB will have to ease further).

13. For the time being, **the link between money supply and inflation remains broken. Because households and business are in de-leveraging mode** after the previous credit excesses, monetary policy is effectively pushing on a string.
14. **In Japan, where gross public sector debt is almost 200% of GDP, expansionary policies including zero interest rates have not succeeded in stimulating demand and consumer prices. Deleveraging has been going on for more than a decade**, and deflation is well-entrenched (CPI was -1.8% y/y in June). 10-year government bond yields are presently only 1.44%.
15. The future of European and American bond markets could well look similar. **As long as debt-reduction rather than new borrowing and spending is the priority in key segments of our economies, there is little risk of a serious pick-up of inflation. I find it actually surprising that inflation expectations are not much lower than they are.**
16. Bond markets also benefit from **strong demand for fixed-income instruments**: high stock market volatility, the suspicion that stocks are once again overpriced, weak housing markets, very low deposit rates and economic uncertainty have driven investors, including households, into bonds.
17. **Corporate bonds have been the stars of the season** because they have an acceptable risk/return profile, a predictable and relatively generous cash flow, they are easy to understand, and it is money back at maturity. As risk aversion has been declining, **emerging market bonds** have also done well. Bond issuance is running in top gear. Even so, the risk that a new bubble is inflating appears remote right now. According to Merrill Lynch indexes, the average yield on dollar-denominated investment grade bonds is about 5.5%, and 11.6% on high-yield bonds (junk). Safety margins vis-à-vis government bond yields are generous. Note that the actual American CPI inflation rate is -1.4% y/y.
18. **Why is the dollar so weak?** When, as today, America’s economic statistics are better than Europe’s, the demand for dollar and the dollar exchange rate are supposed to rally. Market participants assume that profits would rise more than in Europe, as would short-term interest rates. So what is different this time?
19. **Good US news seems to be bad for the dollar.** The most plausible explanation is that America’s economy still faces strong head winds which forces the Fed to keep short rates firmly anchored at close to zero. **Mr. Bernanke** has actually made this very clear during his Humphrey-Hawkins testimony before Congress. **Mr. Trichet** uses a tougher language and is expected to apply his exit strategy on the first signs that the economy has turned the corner. I do not see it this way, but markets do.
20. **On the basis of changes in current account balances the dollar should actually appreciate.** Since the US saving rate has increased so much during the deleveraging process, there is less need for capital imports. These are also down because capital spending is weak (-27.4% y/y in real terms in Q2, and -26.8% y/y in nominal terms). Fewer capital imports mean a smaller current account deficit. One of the most threatening global imbalances is thus on the mend.

21. **Perhaps it is wrong to focus on the balance on current account as a driver of the exchange rate**, though. It could be that it is rather the explosion of US government debt that sends investors reeling – the world is flooded with dollar denominated paper, and foreign portfolios are overflowing with this kind of asset. Should this indeed be so, then the weakness of the greenback will persist. Hard to say.
22. **Stock markets and commodity markets have been buoyant this year – investors play the economic recovery story.** As mentioned before, the global economy has reached its cyclical trough during the summer months. Monetary and fiscal policies have been very expansionary for about three quarters, and, given the usual time lags, are now beginning to yield results, ie to stabilize demand. At the same time, inventories have been slashed so much in response to the collapse of demand that it is now time to rebuild them. Hard economic data have finally begun to confirm the improvement suggested by increasingly positive survey results. US housing in particular, which had been the trigger of the global recession, has reached bottom and is no longer a drag on demand – if not much of a booster either now that its share in overall activity has become rather small.
23. **A sharp rebound in economic activity is normal after such an exceptionally severe recession** – global real GDP has dropped at annualized rates of 7 ½% during the two winter quarters. Especially manufacturing activity had been hit hard, just as world trade which has declined by more than 10% in real terms. **Profits usually rise more than proportionally**, just as they had fallen more than proportionally during the recession. The main reason is that the reduction of slack lifts revenues but more than costs – unit labor costs fall.
24. **Stock prices tend to overshoot both on the way down and on the way up. And the steeper the fall, the stronger usually the rebound.** To recall: the **Dow Jones** had crashed 88.7% between September 1929 and June 1932 (monthly averages), and had then gained no less than 337% until February 1937 which was one of the longest and steepest recoveries of a stock market on record. The old 1929 high was reached only in 1954 though; in inflation-adjusted terms actually only in the mid-sixties. Or take Japan: the **Nikkei 225** fell 62% between the end of 1989 and mid-August 1992, only to bounce back by 42% until September 1993; in the following years the index moved wildly up and down along a falling trend and is today still 73.4% below its level of December 29, 1989.
25. The **Shanghai market** had shed 72% of its “value” between October 2007 and November 2008, and has since risen by 103%. The **Russian RTSI\$** was down 80% in the eight months following May 2008, and then gained 116% (but is still 57% below its peak). The pattern is similar in other emerging markets. **For investors there is no reason not to participate in such rallies, as long as they operate with stop-losses.**
26. **Less volatile Western stock markets have also been on a firm uptrend since mid-March when “green shoots” were first spotted. The S&P 500 remains 36% below its high, the DAX 33%.**
27. It is now **time to reduce the portfolio weight of markets which have rallied most.** Some of them have reached heady valuations, among them Shanghai, Indonesia, South Korea, Taiwan, perhaps Brazil. These markets have anticipated a lot of good news, but as long as exports to the OECD area are not catching on they remain on shaky ground.

28. I suspect that **even Russia, in spite of its 2009 price-to-earnings ratio of just 9 and a price-to-book ratio of 0.95, is not a bargain any longer.** The main stocks as well as the exchange rate of the rouble, but also government revenues move up and down in step with the notoriously volatile oil price. The higher the oil price, the higher the risk of a correction. At \$72 per barrel, oil is no longer cheap. It has reached a region where it hurts oil importing countries once again: it reduces their purchasing power and therefore overall demand. It makes it more difficult to overcome the recession. This in turn will bring down the oil price, with all its negative implications for Russia. I would be more confident if the government used the relatively benign environment to improve the institutional framework and the dilapidated infrastructure in order to wean the country off its addiction to oil. Not much is happening in this respect.
29. **In China's wunder economy there is today once again the risk of asset bubbles,** fuelled by flush liquidity and low interest rates. Given the country's obsession with a quasi-fixed dollar exchange rate, it is hostage to Fed policies. As mentioned above, to avoid an appreciation, an almost unlimited amount of dollars is bought against yuan, while interest rates can not be raised. **3-month interbank repo rates are at 1.7%, compared to a growth rate of real GDP of almost 8%.** Such a discrepancy is a recipe for disaster. Because of the dollar peg it is impossible for the central bank to "lean against the wind", as it should. The result is almost inevitably a misallocation and waste of resources – too much investment in property – and overinvestment in general, especially in infrastructure and manufacturing. A new crash is only a matter of time, followed quite likely by a rather long period of slow growth. As long as China maintains its dollar peg there will be no "decoupling" from the US economy.
30. **Growth is rebounding in the OECD area.** The medication of low interest rates, generous funding support, bank rescues, fiscal stimulus and low inflation has finally stabilized demand. Inventories seem to be lean while households and business have accumulated some pent-up demand. It can be expected that the **news flow will be positive for the rest of the year,** and it would therefore be dangerous for investors to bet on falling stock prices.
31. It is **unlikely that policy support will soon be withdrawn because it can not be taken for granted that the recovery is self-sustained.** But nor do I see that this support will lead to new asset price bubbles in developed economies.
32. **There are still considerable risks that have to be watched closely:** 1. banks will be faced with a further increase of non-performing loans as unemployment, a lagging indicator, continues to rise, as will the number of bankruptcies; 2. banks can not yet lend freely because their balance sheets are still weak; 3. in the US, and probably in the UK and Spain as well, house prices keep falling, putting more and more households financially under water – they will not become exuberant shoppers for years to come; 4. some countries, especially in Eastern Europe, are teetering on the brink of default, perhaps mortally wounding some Western banks; 5. some jobs are gone forever, for instance in auto production and financial services – structural unemployment will therefore be high for a while; 6. world trade will not recover any time soon, and 7. deflation, if it can not be overcome quickly, will lead to a postponement of purchases which would be a blow to demand.

33. This is a long list of risks, and I am not even sure it is comprehensive. Add to it the **possibility that the recent rally has made equities too expensive**. The 2009 price-to-earnings ratios for the main stock indices are almost all in the mid-tens. This translates into earnings yields of about 6.7%. Since real bond yields are presently in the order of 4 to 5% (Germany and the US), calculated on the basis of actual y/y inflation rates, ie deflation, the risk premium, as the difference of the two metrics, is unusually low, just 3 to 2 percentage points – 5 would be normal. Investors are not afraid of risk these days. Let's hope they won't regret it.