Dieter Wermuth

Wermuth Asset Management GmbH

60329 Frankfurt am Main, Mainzer Landstrasse 47
Phone -49-69-95 92 54 78 , Fax -49-69-95 92 54 79
E-mail: dieter@wermuthAM.com

Investment Outlook

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1. **The global bull market in equities is now one year old. During that time stock indices have recouped about half the losses suffered in the crash that lasted from late 2007 to early 2009, in line with the recovery of the global economy.**

2. But **stock markets in developed countries are still** between 23% (DAX, S&P 500) and 45% (Nikkei, EuroStoxx50) **below the highs of March 2000**, the month that marked the turning point of the new economy bubble. Indices of emerging markets such as China, Brazil and Russia have moved well above the levels of 2000 (75%, 320% and 540%, respectively), reflecting the much higher growth rates of output and corporate earnings, as well as the progressive decoupling from rich world developments. Roles are actually reversing – emerging economies have achieved, or are on the road to, self-sustaining growth and have become the world's growth engine.

3. From here on, the **momentum of most of emerging markets is about to slow somewhat**, though, because excess capacities are shrinking. A sign of this is rising inflation; in India, for instance, consumer prices exceed their year-ago level by more than 16%, and Chinese annual inflation has moved from -1.6 % one year ago to +2.7%. All **central banks of emerging economies are raising interest rates, with the exception of Russia's;** there, a huge output gap and a strongly appreciating currency exert downward pressure on consumer prices and policy rates.

4. **For emerging market stock indices, the slow-down of productivity growth and rising interest rates are important counterweights to the still-robust growth of output.** Valuations are not really cheap across the board because stock prices have gained so much since early 2009. This is especially true for India. Brazil and Russia may look expensive as well on the basis of trailing price-to-earnings ratios, but corporate earnings will rise quickly on the back of the new commodity boom. On the basis of expected profits, both markets do not yet look overpriced. China's trailing valuations are still only about half as high as in the heady days of late 2007. **On a general note, index tracking looks less promising at this somewhat advanced stage of emerging market stock indices than stock picking, i.e. a focus on micro stories.**

5. **Output gaps are still rather large in the OECD area.** Unemployment is not rising any more, but it is still high and people are not yet optimistic about their financial situation. Wage settlements remain more than modest – in real terms, hourly wage increases of euro area, American and Japanese workers are negative or not much different from zero (y/y). At

the same time, firms find it difficult to raise output prices; price wars are a typical effect of low rates of capacity utilization. Average costs can be reduced, and profits raised, by boosting output - raising prices is presently not the top priority.

6. **All this bodes well for future inflation. Headline numbers in the OECD area have risen considerably over the past year, but core inflation which excludes energy and food is still on the way down** and virtually guarantees that the Fed, the ECB, the Bank of Japan, the Swiss National Bank and the others will keep policy rates close to zero. Analysts are divided, for instance, over the timing of the first increase of the Federal Funds rate: it could happen by mid-2011, or in 2012, but not earlier. The risk of deflation is still lurking in the back of central bankers' minds. **Low interest rates, together with the prospect of robust growth of productivity and corporate earnings provide solid support for OECD stock markets.**

7. **Just as global stocks, commodity prices have made up much of the ground lost in the second half of 2008.** Since the economic recovery is driven by dynamically expanding emerging markets and thus, not surprisingly, by industrial production, the **demand for commodities has been buoyant.**

8. **On a purchasing power parity basis, global real GDP has been growing at an annualized rate of 4.3% during the two winter quarters**, and by 3 ½ % on the basis of actual exchange rates. In terms of purchasing power, emerging and developing countries have a share of 50% in global output. The key aspect is: they continue to expand more than two times faster than developed markets – during the winter growth rates have been 6½% versus 2.7%. **Going by presently available leading indicators, both the momentum and the superior performance will be maintained during the remainder of 2010.**

9. **And industrial production is particularly strong** – the following numbers are the most recent year-over-year changes in per cent: China 12.8, India 16.7, Poland 9.2, Turkey 12.1, Singapore 19.1, South Korea 36.9, Taiwan 35.2, Thailand 30.3, Argentina 8.2, Brazil 16.0. These are breathtaking statistics. To some extent they reflect the very low base one year ago, but it seems that the message does not change much if a shorter and thus less distorting time horizon is chosen.

10. **Prices for essential inputs** such as crude oil, iron ore, coal, steel, copper and nickel **have increased steeply since early 2009**, mostly by more than 100%, and some, such as copper and gold are already near their all-time highs and thus look bubbly.

11. **World trade expands very much in synch with industry**: according to the Netherlands Bureau for Economic Policy Analysis which monitors trade volumes, these were 13% above the trough reached in May 2009. This confirms the rule of thumb which says that in non-recession years trade expands almost two times faster than real global GDP.

12. Freight rates have recovered a lot (+340% for the bellwether Baltic Dry index from its low of December 2008), as would be expected, but there is still much excess tonnage. Most of the additional trade is among Asian countries these days, including Australia, rather than cross-pacific or cross-Atlantic. This is probably the reason why **the freight index, in spite of its recent rebound, remains no less than 75% below its May 2008 peak. It may also be a warning sign that not all is necessarily well already, or that it will be plain sailing from here on.**

13. As an aside: even in supposedly moribund **Japan industry has been able to boost its output by an unheard-of 31.3% y/y in February.** China and the rest of booming Asia is right next door, and Japan obviously produces the right consumer and capital goods. The US is no longer the most important destination for its exports. That China's first quarter real GDP may have exceeded its year-ago level by no less than 11.7% (release date April 15) suggests that the tectonic shift in world trade patterns has only just begun.

14. **Emerging markets have recovered so quickly from the slump because people there are at the same time poor and thrifty.** They want to catch up quickly with their cousins in the richer parts of the world – about whose living standards they are increasingly well informed, thanks to the internet, soap operas on TV and cheap telephony. By now, these countries have the independent financial means to pay what it takes to buy the goods and services on their shopping lists. Moreover, probably as a corollary, households and banks are not pre-occupied with deleveraging, ie cutting their debt. Debt levels have been manageable throughout the crisis, with Russia, the Baltic countries, Dubai and Greece as major exceptions.

15. The "independent financial means" show up in the development of world currency reserves; these are once again at record levels. For the world economy as a whole, this is a mixed blessing. It shows that emerging economies are net buyers of dollars and, to a lesser extent, euros as they try to prevent their currencies from appreciating. **The old imbalances are thus re-establishing themselves.** For the US, in particular, it will be difficult to reduce its current account deficit much further. It is presently 3.2% of GDP, down from more than 6% three years ago, and is unlikely to shrink meaningfully from here on. Capital is flowing uphill again, from poor countries to the rich.

16. While emerging economies are growing briskly again, **developed economies, the other half of the world, may also be on the brink of a self-sustaining recovery.** Last week, in its interim assessment of the economic outlook, the OECD has listed a number of positive so-called high-frequency indicators that point to continued growth in the Group of 7 - to an annualized growth rate of real GDP of 1.9% in Q1 and of 2.3% in Q2.

17. **Most importantly, financial conditions in the OECD area have eased a lot**: interest rate spreads between 3-month LIBOR and same-maturity government debt in the dollar, euro and yen markets have almost fallen to pre-crisis levels, yields of high-yield and other corporate bonds continue to decline, share prices are rising (raising equity has become cheaper), yield curves are very steep, as central banks keep policy rates close to zero in nominal terms, and in negative territory in real terms (deflationary Japan, of course, is an exception in this regard). **For the euro area, an additional positive contribution to financial conditions has been the weak euro exchange rate, thanks to the financial problems of Greece.**

18. **OECD countries have also "benefited through trade linkages from strong activity growth in major emerging-market economies,** including China, India and Brazil." This is a dramatic reversal of traditional roles. More specifically, the US consumer is not the driver of global demand any longer. Domestic consumer and business demand in what used to be called the second and third world has taken over the leading role. The OECD report has also pointed out that global imbalances have widened somewhat. But a look at the numbers shows that the situation is far less explosive than in 2004 to 2007. It is still early days.

19. **Most internal non-financial indicators in developed countries are also strengthening, such as private consumption (not least in the US), house prices and business confidence. The euro area is the clear laggard among G 7 countries**, but the OECD report fails to say why this is so. Perhaps government deficits are too small (!?), or the ECB has kept the main refinancing rate at 1% rather cutting it further. Sometimes the argument seems to boil down to the statement that euro area growth is so weak because the euro area is the euro area, a hopeless case. According to the report's estimates, Germany's economy has shrunk by 0.4% q/q annualized in Q1, in spite of very strong leading indicators, whereas the US has expanded by 2.4%, the UK by 2.0%, France by 2.3% and Japan by 1.1%.

20. The determined efforts of monetary and fiscal policy makers to do what it takes to prevent a depression have been successful so far. Keynes is back. **The main risk going forward is an early withdrawal of policy support.** As it is, the private sector in the OECD region is still in the process of repairing its balance sheets which had been badly damaged by the collapse of asset prices such as property, equities and structured financial products: spending grows by less than income – private sector savings rates are on the way up, most dramatically in Spain, Ireland and, probably, Greece, but also in the UK; worryingly, in the US, the household savings rate has fallen from a less-than-impressive long-time high of 6.4% last May to just 3.1% again.

21. **No one knows for sure how long it will take the private sector to reduce debt levels, but if Japan's experience is any guide, it will be quite long.** This is incidentally also the conclusion of Carmen Reinhart's and Ken Rogoff's recent book on the history of financial crises ("This time is different"). Investors can be fairly confident that the near-term outlook for output and profits is benign, but longer-term they must be wary about the effects of de-leveraging in key developed markets. Emerging markets are mostly less affected.

22. **For some investors, bond markets look rather expensive** at this stage, given record-large government budget deficits, rising headline inflation and the explosive growth of central banks' balance sheets. They should not worry too much. I am not really surprised that, for instance, 10-year government yields are at 1.39% in Japan, 1.96% in Switzerland, 3.2% in Germany, 3.92% in the US and 4.04% in the UK, all of them close to historical lows.

23. **The main driver of yields is capacity utilization – which is still depressed, especially in developed economies.** Higher commodity prices may have pushed up headline inflation, but inflation expectations have not gone up in tandem, and, as mentioned, core inflation remains on a downtrend. In the US and the euro area, it will reach less than 1% toward the end of the year. In Japan, it is -1.2 % y/y already. In the long run, headline inflation tends to fluctuate around core inflation, meaning that the former could well fall below the latter in the next two or three years. Bond holders are right to be relaxed about inflation.

24. The Fed has clearly signaled that the Funds rate will not be raised any time soon. The ECB may be talking about gradually moving to the exit, but in view of the sluggish recovery of the euro area, the prospect of sub-target inflation and the Greek crisis, it is just that: talk. In Japan, persistent deflation will prevent any tightening, the Swiss central bank is worried about the strength of the franc (a perceived safe haven for holders of euros), and the Bank of England must maintain easy monetary conditions as the next British government starts to pull in the fiscal reins.

25. **In short, bonds in key developed markets will continue to benefit from very low policy and money market rates.** The risk is small that bond markets will suffer in earnest from a near-term tightening of monetary policies. For the time being at least, falling bond prices are buying opportunities. Note that it is also in the interest of central banks that yield curves are steep – it is the easiest way to restore the health of the banking sector and stimulate lending. It also is not dependent on taxpayer money.

26. **How about exchange rates? To start with the euro**, it has fallen by 6% in trade-weighted terms from its recent high on October 23, and from $1.51 to $1.36 bilaterally. The main reason for this weakness, as far as I can see, has been the Greek debt crisis. The **fundamentals of the euro area are actually rather sound** and are not moving in the wrong direction: consumer price inflation is 1.5% y/y (US 2.1%), 3-month LIBOR costs 0.58% ($-LIBOR: 0.30%), the current account deficit will reach 0.2% of GDP in 2010 (US: 3.2%), and the aggregated budget balance is expected to be –7.2% of GDP (US: -11.1%).

27. **Greece is a small country which will and can be saved by the other members of the monetary union.** Its share in euro area GDP has been just 2.66% in Q4, and total government debt is ”only” about half the size of Lehman’s before its collapse. There are two problems which are not really solved yet: one is moral hazard – will the rescue package’s easy terms, i.e. below-market interest rates, prompt others such as Spain and Portugal to ask for similar favors? -, the other is the no-bail-out clause of article 125 of the Lisbon treaty – would a bail-out like the one just presented force Germany, with its strict and powerful constitutional court, to leave the currency union? German tabloids and also the more reasonable parts of the population are strongly opposed to offer taxpayer money to a spendthrift and cheating foreign government.

28. Why can’t Greece tighten its policies the way Ireland has tightened its policies? The economic risks for the others would be small. Mr. Trichet of the ECB has already stated that deflationary policies in parts of the euro area economy are sometimes acceptable and desirable if previous excesses need to be corrected. The question, of course, is **what would happen if much bigger countries such as Spain or Italy were forced to tighten policies in a recessionary environment. Is it conceivable that the others would really come up with a rescue package of something like €150 bn? The euro is not yet home safe.**

29. According to yesterday’s plan, €15 bn of support will come from the IMF at very favorable rates, and up to €30 bn from the 15 other euro countries at about 5% - in case Greece runs out of money-raising options. Two predictable effects have already occurred this morning: the yield of 10-year Greek government bonds has fallen by about half a percentage point to 6.7%, and the euro has rebounded vigorously to $1.3630. Further corrections are likely.

30. **The Chinese government is under pressure from the US and mainstream economists to allow the yuan to float, i.e. to appreciate against the dollar.** It looks as though these efforts will succeed to some degree. For one, China may be afraid that domestic inflation could get out of hand. A stronger currency would lower export and import prices and lead to more intensive competition and is thus desirable. Intervening to hold down the exchange rate has the unpleasant side effect that money supply rises very fast – M2 has been +25.5% y/y. Buying dollars means creating yuan. And currency reserves have reached $2.5tr already, more of a third of the world’s total. Why subsidize the US taxpayer? Second, the Chinese administration is probably afraid of trade sanctions if they do not move soon on de-pegging the yuan.

31. Both are reasonable points. **I still think that fixing the exchange rate against the dollar is a very smart policy: maintaining a competitive edge (a slightly undervalued currency) and avoiding potentially large swings in the yuan's external value strengthens the domestic investment climate and promotes growth.** Post-war Germany and Japan and, later, the so-called Asian tiger states have successfully based their catching-up processes on similar strategies. Growth was high as long as the exchange was fixed.

32. **In the Chinese case, the GDP growth is now so strong that imports are rising much faster than exports** (Q1 exports were +30.3% y/y, imports +65.4% !!!), and the trade surplus has fallen to $14.5bn in Q1, after $62.5bn one year ago. In economists' terminology, the positive income effects on the rest of the world of a strongly growing economy are now stronger than the negative price effects of an undervalued exchange rate – China has begun exporting jobs on a massive scale. Who would complain? If I were a Chinese policy maker I would make some friendly gestures but maintain the basic strategy. It is in everybody's best interest, including the Americans'.

33. **Commodity currencies have been very strong recently. The Canadian dollar** has now reached parity with the US dollar – in March 2009 Canadians had to give up 1.3 of their dollars to buy one US dollar! In the case of **Australia,** Americans paid 0.63$ for one Australian dollar in March 2009, compared to 0.93 today, an appreciation of the A$ by no less than 48% - in a little more than a year. These are the wonders of commodity price volatility.

34. **The rouble is in the same camp**. It also follows closely the ups and downs of commodity prices, especially the oil price. If oil prices fall, the balance of trade deteriorates, the international demand for rouble assets declines – the rouble depreciates. And vice versa. Shortly after the oil price had hit bottom at the end of 2008 ($35 per barrel) the Russian trade surplus fell to its lowest level for many years ($4.6bn in December 2008) – it is now back at $15.2bn, close to the $19.0bn record of January 2008, on the back of the oil price rebound to $78 (today $85 pb for WTI) and depressed domestic demand, i.e. depressed imports. Average real GDP had fallen by 7.9% y/y in 2009 – while the business cycle has turned around the middle of last year, the rate of capacity utilization is still quite low and imports are still far below pre-recession levels. In February, merchandise imports were only about half as high as in July 2008, the peak month of the previous import boom.

35. **Against the dollar/euro basket** (0.55 roubles per dollar + 0.45 roubles per euro) the Russian currency has moved from a low of 40.94 in February 2009 to 33.68 today, an **appreciation of 21.5%**. Since the beginning of 2010, large inflows from abroad into Russia-focused funds have also contributed to the strength of the rouble: relatively low asset prices and positive growth prospects because of the new commodity boom are an attractive combination for foreign investors.

36. The administration is once again worried that the rouble's appreciation may become too much of a good thing. While it helps to keep inflation in check (consumer prices were +6.5% y/y in March, after +14.0% in March 2009), it has a **negative impact on international price competitiveness, thus hurting exports, domestic production and jobs.** This is why the central bank keeps buying dollars and euros on a massive scale again – foreign exchange and gold reserves have risen by about $70bn over the past year, to $447bn. One predictable effect of these interventions is money creation: **in February, M2 was no less than 29.5% higher than one year ago. Liquidity has begun to drive Russian stock markets once again.**

37. For the time being, **the positive effects of an appreciating rouble on inflation dominate over the negative effects of money (and, soon, credit) growth**. Unemployment is still high, though falling, and real wage growth is rather moderate. There is no new inflation mentality yet. It is therefore likely that the central bank will continue to cut interest rates, not least in order to keep out speculative money. Policy options are not straightforward – lower interest rates improve the outlook for rouble bonds and may actually lead to more capital inflows, the opposite of what is intended.

38. **At some point Russia has to stop pegging its exchange rate** loosely to some foreign currencies. Independent monetary policies are only possible if the exchange rate is allowed to float. The other alternative is an absolutely fixed exchange rate, for instance against the euro, the currency of the country's key trading partner. The present mixture of fixed and floating combines the worst of both systems.

39. **Near-term, the rouble appreciation will continue.** There are no signs that commodity prices are about to crash or that Russian imports will explode. Nor is it likely that portfolio investments will dry up: asset prices are low by international standards (i.e. risk premia are very high, probably too high). The main risk is that the world may be heading toward a new commodity price bubble, perhaps in step with the creation of new property bubbles in large emerging markets such as China or Brazil.

40. **To conclude: The global economy is expanding briskly, especially industrial production. Commodity prices have increased for more than one year and will probably move sideways from here on. Headline inflation is picking up and is about to become a problem in emerging markets, requiring higher policy rates there. In developed countries, core inflation is still on the way down: output gaps are large, wages rise only moderately. Central bank rates of OECD countries will remain very low because of high unemployment, on-going deleveraging (private sector debt reduction) and below-target core inflation. Good-quality bonds are thus well-supported. The best near-term outlook for equities is in markets where output gaps are still large (most OECD countries, Russia) – large productivity gains and moderate wage increases will boost profits. For different reasons, the euro and the rouble will appreciate.**