

Investment Outlook By Dieter Wermuth

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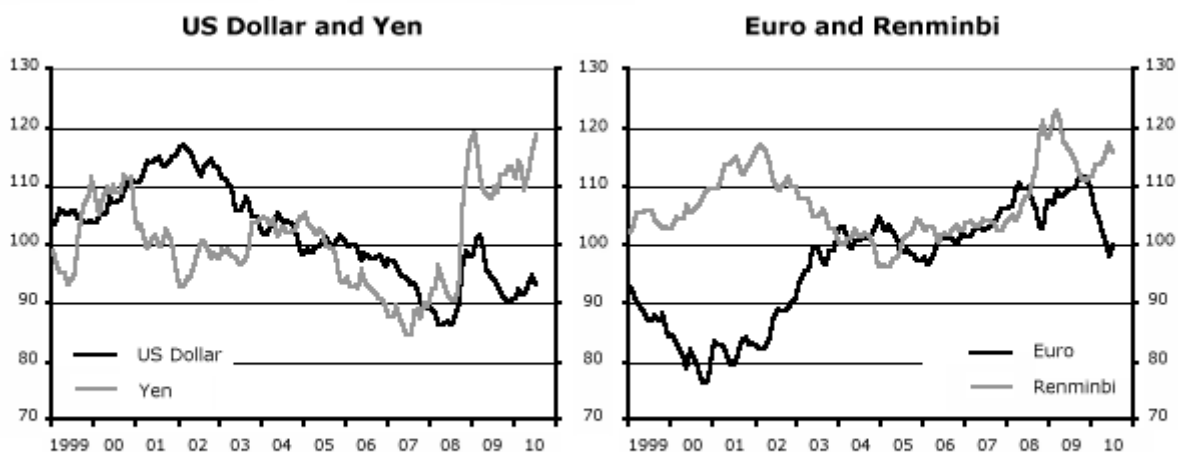
- **On balance, the world economy is doing quite well.** There are no major asset price bubbles that are yet to pop, so there is little risk that stock, commodity or real estate markets will get another beating in the foreseeable future. Recovery from the Great Recession proceeds at varying speeds, depending on the extent of deleveraging that is needed to repair private sector and government balance sheets after the crash of asset prices and tax revenues.
- **In rich countries, output gaps are very large and employment gains are moderate at best – disinflation continues and deflation has become a non-trivial risk** in some countries, especially in the US. Monetary policies remain expansionary in such an environment and will not be tightened any time soon. This means that sovereign bond markets are well supported, even though nominal yields have already fallen to historically low levels. Corporate bonds are a natural alternative for investors looking for yield which in turn is driving down spreads over government bonds.
- **Recessions in emerging and developing economies had mostly been mild** - with the notable exceptions of Russia, some other East European countries and several Latin American countries. Even there, as in the rest of this part of the world, **growth is already quite robust again** and has reached pre-crisis rates. Since output gaps are thus relatively small, inflation is on the way up and averages about 5%. **Central banks have begun to tighten policies, if only cautiously.** In general, interest rates are lower than the rate of growth of nominal GDP which stimulates borrowing, investing and output – **monetary policies are actually still very expansionary.**
- At actual exchange rates, real GDP of rich countries expands at a rate of about 2 ½% in Q2 and Q3; in emerging economies the rate is more than two times higher, as one would expect. **Industrial production and world trade exceed year-ago levels by more than 10%.** While both are still well below pre-2009 trend lines, the gaps are closing. Container shipping lines report record profits again, and the number of idle vessels has declined from almost 700 at the end of 2009 – the year of the deepest slump ever - to less than 200 now.
- The **sense of unease that is presently prevailing among market participants** is caused by the fear that the slow-down of growth in the US, in China and Japan – which together account for almost 40% of global output (at purchasing power parity exchange rates) - will have negative effects on other countries, as well as commodity prices. Stock markets are treading water or fall. The few exceptions this year are the super-solid Scandinavians, the three Baltic countries which had been severely hit last year, Poland, the Czech Republic, Germany and, in Asia, Malaysia, Thailand, Indonesia, the Philippines and India.

The US economy loses momentum

- How fragile is the American economy? In the second quarter, corporate earnings have mostly surprised on the high side while revenues came in more or less as expected. But **investors are decidedly bearish about the outlook. This is reflected in a p/e ratio of only 13.1** for the S&P 500 (estimated 2010 earnings), i.e. an earnings yield of no less than 7.6%. Since the nominal yield of 10-year US Treasuries is only 2.6% and thus about as high as long-term inflation expectations, the real Treasury yield is around zero. In other words, the risk premium on US stocks, the difference between the earnings yield and the real yield on riskless assets, is in the order of 7.6 percentage points, a record high I would think.
- There are **two main reasons for this skepticism: the US recovery has been losing momentum in Q2, and it has been a jobless recovery so far.** After the publication of the steep increase in the trade deficit in June, analysts now predict that the second quarter real GDP growth rate will be revised down from 2.4% to just 1.2% annualized. Employment growth is also uncharacteristically anemic at this stage of the business cycle. Going by the household survey, the number of jobs is still 5.1% smaller than in November 2007, its all-time high, and increasing at an annualized rate of only 1.5% from the low of December 2009. Employment has actually declined over the past three months. **On labor markets, the recession has not yet ended.**
- **Business is unusually cautious about hiring because consumer demand is subdued.** For many households, **reducing debt and spending less has top priority.** The value of their homes has fallen by an average of no less than 29.1% from the cyclical high of July 2006. While prices have recovered by 5.1% since the April 2009 low, the broad trend is of stagnation at a depressed level. The inventory of unsold homes and the number of foreclosures are at record highs. At the same time, the broad S&P 500 stock market index is still about 30% below its recent peak of October 2007.
- All this implies that **consumers, the traditional drivers of US business recoveries, are hit by massive wealth effects and suffocate under mountains of debt.** Their shopping instincts have been weakened and will not generate enough final demand to contribute significantly to overall GDP growth.
- **Money printing**, defined as loading up the Fed's balance sheet with government debt and de facto government guaranteed paper, **is in full swing again.** The so-called **money multiplier has broken down**, though, as it tends to do when potential borrowers are mainly interested in deleveraging and can thus not be lured into borrowing and spending, neither by easy credit conditions nor by near-zero interest rates. We have seen this happening in Japan. The US is so far closely following that unpleasant role model. In July, broad money supply **M3 was down 4.2% from one year ago, and bank loans were down no less than 7.4%.**
- **Not much additional stimulus to demand can be expected from government spending** either. Budget deficits are so high that there is almost no room for maneuver any more. If unchecked, government debt levels will reach a Greek-style 120% of GDP by 2015. At such levels, the independence of the central bank is no longer assured – because it becomes an agency of the Treasury - , and markets may begin to speculate against the currency (if there are plausible alternatives).

- Should the US indeed follow the same path as Japan, **today's 10-year bond yields of 2.6% must not be the end point**. Core consumer price inflation has been +0.7% annualized over the past seven months. To everybody's relief it has recently stabilized and deflation is thus not an imminent risk. But output gaps remain large, including the underemployed labor force - firms' pricing, and workers' negotiating powers are correspondingly weak. Inflation expectations, which are a key determinant of bond yields, are more likely to trend down than up.
- Add to this the clearly stated strategy of the Fed to stay put with regard to the Funds Rate, i.e. leave it near zero. Most analysts actually do not expect a rate hike before the summer of 2011. 3-month dollar LIBOR, a benchmark money market rate, is now at 0.35%, while 3-month US Treasury bills are just 0.15%. So **in spite of record-low long-term yields, the yield curve is still fairly steep**. It is an attractive and low-risk strategy to borrow at short maturities and invest long. This is, incidentally, one way to help banks generate the profits they need to improve their balance sheet ratios. It is also a massive subsidy to the financial sector. One predictable effect is a further reduction of medium and long-term bond yields. Just to show what is possible: Japan's 10-year government bonds are presently trading at only 0.9% (in June 2003 the yield had actually fallen to 0.45% at one point!).
- **One factor that has pushed down US inflation this year has been the strength of the dollar**. Since US debt vis-à-vis foreigners is in dollars, even large government budget deficits are not as life-threatening as those of, say, Greece, Ireland or Spain. As members of the euro area, these highly indebted countries do not have an own central bank any more and their debt is thus denominated in a currency which is not under their control. The likelihood of European sovereign defaults was rather high at times, as market participants feared that the no-bailout clause of the Maastricht Treaty would apply. So in spite of US government deficits of more than 10% of GDP the dollar was regarded as a safe haven currency which in turn triggered an appreciation process, especially against the euro, but also against sterling which tends to be highly correlated with the euro.

nominal effective exchange rates^{*)} (2005=100)



^{*)} monthly averages

Source: Bank for International Settlements

- In the meantime, huge rescue packages have been proposed by euro area member states and the IMF, and strict fiscal policy surveillance programs are in place now. In parallel, the ECB has begun to buy bonds of weaker euro members which not only stabilized yields but also helped to reduce the exposure of euro area banks to these “peripheral” countries and thus the systemic risks in case of sovereign defaults. Market participants are still afraid that this may happen after all – 10-year Greek bonds still yield 10.6%, Irish bonds 5.2%, Portuguese bonds 5.1%, while Spain is out of the line of fire for now - but are also **convinced that such an event can be handled with the tools that are now available. The euro has thus rebounded from its early-June lows against the dollar.**
- From a US perspective, this is welcome. It reduces the risk of deflation, just as the recent devaluation of the dollar against the yen, and could mean that the US does not follow the Japanese model after all. The yen is a structurally strong currency – which tends to exacerbate deflationary trends – while the dollar is structurally weak, a result of the low US national savings rate. **The more the euro appreciates against the dollar (the yen appreciates anyway), the lower the risk of US deflation. I assume that the dollar exchange rate will trend down further from here on. This increases the probability that dollar bond yields and US stock markets will bottom out. To be sure, though, I do not expect this to happen in the near-term.**

China about to resume rapid growth

- **The other major reason for the present investor unease is China. The government and the People’s Bank had tightened the reins beginning in the second half of 2009** to prevent stock and real estate markets from overheating, to prevent the accumulation of non-performing loans on bank balance sheets and to fight inflation before it got out of control. Reserve requirements and interest rates were raised several times, banks were advised to slow their lending, and restrictions were put on the purchase of second and third homes. Recently, the exchange rate of the renminbi against the dollar has been allowed to drift gently upwards (it has moved only from 6.82 at the end of June to 6.79 RMB to the dollar today).
- All this had the effect that **real GDP growth declined from recent rates of 11% and more to about 8% by mid-2010.** Industrial production is now expanding at rates of 10 to 13% rather than 18%-plus previously. Stock markets are down this year, and perhaps even real estate inflation is moderating (we lack reliable data). Portfolio investors were not expecting a genuine recession but the apparent slowdown of output growth was enough to sent shudders down their spines. They **had hoped that China would take over from the US consumer as the buyer of last resort.** For this to work, Chinese growth had to be very high – the country’s GDP may now be larger than Japan’s but it is still only one third of America’s.
- By now, **China’s growth strategies are back in place.** The government has decided to promote investment in the remote but overpopulated interior of the country, called urbanization, with the aim of bringing jobs to the workers. The strategy of bringing workers to the jobs in the booming coastal areas made less and less sense. Minimum wages were raised a lot (but are still only in the order of 100€ per month). At about +14½% y/y, real retail sales continue to boom and show that domestic demand is strong. Foreign trade (net exports) will be a drag on Chinese growth this year.

- Overall, economic policies are fairly expansionary.** While the budget balance will be in the order of -2.8% of GDP this year (which looks modest compared to the numbers we get from OECD countries), the **main stimulus comes from the monetary front:** policy rates are well below the rate of growth of nominal GDP (of 13% to 14% y/y), M2 will exceed its year-ago level by about 17%, bank lending will be in the same order of magnitude (inflation is 3% y/y), foreign currency reserves are rising rapidly again and will reach \$2.7tr by year-end as the trade surplus has begun to rise again. It is impossible for the central bank to fully sterilize the money created by the massive buying of dollars and euros. So there is no lack of liquidity.
- The Chinese will put 16 million new cars on the road. The country has passed the US and the euro area as the world's largest auto market. No country consumes more energy than China, or more steel or cement or various other commodities. On the basis of a gross national savings rate of 51% and a **gross capital formation rate of 46.4% of GDP** this year and in the foreseeable future, China has the means to grow at very high rates for many years. It can and does import state-of-the-art technology and will thus maintain extremely fast productivity growth (which is at the core of wealth-creating processes).

An estimate of BRICs' catching-up periods

	real GDP	nom. GDP	nom. GDP per capita	population	catching-up period ²⁾
	aver. ann. growth 1999-2009	2010 ¹⁾	2010 ¹⁾	aver. ann. growth 2005-2009	with US GDP per capita
	%	bn euro	euro p.a.	%	years
	(1)	(2)	(3)	(4)	(5)
Brazil	3.3	1,476	7,638	1.1	126
Russia	5.3	1,110	7,908	-0.4	34
India	7.0	987	812	1.5	88
China	9.9	4,293	3,200	0.5	31
US	1.9	11,283	36,367	0.9	-
Japan	0.7	4,178	32,776	-0.0	-
euro area	1.3	9,237	28,580	0.6	-
Germany	0.8	2,505	30,575	-0.1	-

Notes: 1) estimated, at early August 2010 exchange rates – 2) assuming that the US and the BRIC countries' GDP and population will continue to grow at the rates in columns (1) and (4).

Source: IMF; own calculations

- China is still poor, as the table shows. If real GDP and population follow recent trends, it **will take 31 years to catch up with US per capita GDP** – by that time, though, total GDP will be about 3½ times larger than that of America or the euro area. It seems to me that investors should not worry too much about the sustainability of the growth model and could do worse than betting that China will soon have a comparable structure of demand as in the rich countries, except that the market will be much larger. This includes consumer goods and services (such as health care or tourism) and, of course, commodities. Given this outlook the Shanghai stock market multiple of 15.8, calculated on the basis of 2010 earnings estimates, looks quite attractive. The underlying growth assumptions are probably too low.

Japan is once again losing momentum

- Japan's economic expansion has almost come to a standstill in Q2; real GDP was only +0.4% annualized and 2.0% y/y. Output gaps are huge. From peak to trough, real GDP had fallen by 8.9% y/y, and overall growth since Q2 of 2009 has only been 4.4%. One result is that the **GDP deflator is 1.7% lower than one year ago. Deflation just will not go away.** Real government bond yields are therefore among the highest in rich countries even though nominal yields are so low.
- Japan has very close ties with China: in terms of both exports and imports it has become its main trading partner. Indeed, **exports to China will be the main growth engine this year.** Especially capital goods will do well. This is in spite of the headwind coming from the strong appreciation of the yen exchange rate against all major currencies (see the graph in the US section above). Companies have learned to live with a super-hard currency, though. At 85 yen to the dollar the present rate is much weaker than it was in spring 1995; adjusted for relative inflation trends, something like 60 yen per dollar would be comparable to that level today.
- **In Q2, domestic demand has once again been a drag on growth – it declined by 7.9% annualized in real terms.** The government and the Bank of Japan have very few options: the budget deficit will be 7 ½% of GDP this year, and the debt to GDP ratio approaches 200%. The policy rate is already at 0.1% and can obviously not be lowered further. More aggressive quantitative easing looks appropriate in such a situation: it would also help to weaken the yen (but would, counterproductively, increase Japan's addiction to exports). One suggestion is to persuade companies to reduce their high savings rate by making dividend pay-outs more attractive from a tax point of view.
- **But how to boost consumer spending?** Perhaps a part of the expected increase in corporate earnings of almost 40% y/y will end up in considerably higher bonuses for workers and thus accelerate household income growth. Income and spending are highly correlated. One problem that is hard to overcome, though, is the high real interest rate that savers are getting on their savings accounts – when price indices fall, even cash generates a positive real return! That's one of the reasons why deflation is a bigger problem than inflation.
- Japan's real GDP may increase by 3% y/y in 2010, but net trade will contribute no less than 2 to 2½ percentage points to that growth rate. **Investors are right to suspect that Japan will not be a driver of global growth.** Even so, export-oriented firms are doing well – and they are reasonably priced. Since the yen may appreciate further on the back of a current account surplus in the order of 3½% of GDP in 2010, bonds are not such a bad bet either. The yen may also benefit from emerging economies' attempts to diversify their reserves, i.e. rely less on the dollar.

Euro area economy unimpressed by the risk of sovereign defaults

- In the 16-country euro area, real **GDP growth has accelerated in the second quarter to 3.9%** annualized, driven by Germany's 9.0% rate of growth. GDP was 1.7% higher than one year ago. The drivers were the weak euro, the strong increase of world trade and the inventory build-up that is typical for the early stage of a cyclical recovery, especially after a deep recession: real GDP had fallen by 5.3% between Q1 of 2008 and Q2 of 2009. Output gaps are still very large: if one takes Q1 of 2008 as a starting point for the trend line of potential GDP growth, assumed to be 2¼% p.a., **actual output in Q2 was still 8.3% below potential**. Unemployment stagnates at a high 10%.
- Inflation is thus not an issue in the region. The Harmonized Index of Consumer Prices ex food and energy, i.e. core inflation, was just 1.0% y/y in July while headline inflation was 1.7%. The latter reflects the euro depreciation and the large increase of commodity prices. Even so, both indices are well below the ECB's target. It is not only for this reason that **policy rates will not be raised for some time**. Money supply and bank lending are both close to zero on a year-over-year basis. The ECB considers growth rates of 4½% as desirable in the medium term. Most importantly, the near-default of Greece and the risk that other highly indebted countries such as Ireland, Portugal and Spain might also be shut out from capital markets forces the ECB to maintain its easy policy stance. Banks are responding to the signal and are reporting very strong results. The stress tests came and went. They may have been based on assumptions that were too optimistic, but they still conveyed the message that the recapitalization requirements (just €3.5bn) were manageable.
- **Fiscal policies in the periphery, including Spain, are tightened aggressively, and market participants have been duly impressed**. Only Greece, with its dangerously high debt level, has still a high probability that it may default after all – but creditors have gained some time to prepare for such an event. Moreover, the country accounts for just 2½% of euro area GDP and could thus be rescued without too much effort. The Greek government is quite determined, though, to avoid a default and has pushed through unpopular policies which will bring down the budget deficit by about five percentage points compared to last year. That this will lead to a deep recession is more or less accepted by the population. Economic growth had been rather high over the past decade of euro membership, after all.
- **Taking the euro area as a whole, fiscal policies are not really tightened much this year**. The overall deficit will be 6½% of GDP which is about the same as last year. Since growth could turn out to be somewhat stronger than expected the deficit may actually be lower than that. Even so, deficits of that size are considered to be dangerous for the sustainability of the currency union. Under the stern leadership of Germany, budget consolidation will not slow. The reward for such virtuous behavior comes in the form of very low government bond yields. Germany has just issued a 10-year bond with a coupon of 2¼%, just marginally above the ECB's inflation target.
- **Corporate profits have rebounded strongly this year: output prices and volumes are up briskly while unit labor costs are falling**. Business is presently making up for the decline in earnings over the course of the recession. Given the competitive euro exchange rate, they are confident that they will benefit from the vigorous resumption of global output and trade. The EU Commission's sentiment indicator suggests that they expect growth to continue. Capital spending is probably on the rise again.

- What about **household consumption**, the main component of demand? It seems that employment has begun to increase somewhat – which helps – and that wages are rising faster than consumer prices – which also helps. Consumers in Spain, Greece, Portugal and Ireland will have to deleverage for years to come, but they account for less than one fifth of total consumer demand. The most likely outcome is therefore a modest increase in household spending this year.
- All this means that **real GDP will be up by about 2% from last year**, or perhaps somewhat more. Foreign trade will make a positive contribution but it will be in the order of 0.2 to 0.4 percentage points – the main drivers of demand are domestic.
- **Price-to-2010-earnings ratios for the German, French, Italian and Dutch stock markets are between 11 and 12 and thus rather depressed.** Risks are probably less than assumed. I would also guess that the earnings estimates for 2010 are generally too cautious – they do not take into account the likely strength of the economic recovery and the favorable international price competitiveness. Corporate bonds will also do better than expected.

Commodity prices will move sideways

- Summing up the economic analysis, I think that **the world economy has now entered calmer waters but is moving ahead steadily. Policy support will not yet be withdrawn because there is still a lot of slack and because the US, in particular, is not on safe ground yet. The US is still the world's largest economy.**
- **As to commodity prices, they are supported well in such a scenario.** They had, of course, raced ahead in anticipation that the global recession would end over the course of 2009 and have by now reached levels which are not particularly low, especially when compared to pre-2004 standards. But they correctly reflect the observation that the global economy is undergoing a seismic shift in the direction of emerging markets where the demand for tangible goods is rising rapidly. These require more commodity and energy inputs than services which, as we know, have been the drivers of demand in rich countries in the past couple of decades.
- **So in the absence of some major events such as an Israeli attack on Iran or nuclear warfare in Korea, commodity prices have not much upside potential in the near-term.** A lot of good economic news has already been priced in. They have also been regarded as safe haven investments in a world of money printing and failing sovereign borrowers. As usual, things turn out less catastrophic than impressionable investors usually think. Crises tend to be solved pragmatically. This includes the drought and the forest fires in Russia or the flooding of large parts of Pakistan.
- **Medium-term, commodity prices will rise more or less in synch with global nominal GDP.** Productivity gains in producing and transporting commodities can always be relied upon to keep their prices in check. This does not mean that relative prices can not change fundamentally any time. Overall, commodity producing countries such as Russia will continue to benefit greatly from the gift that nature gave them.