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Investment Outlook

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1. **Markets are driven by expectations that the global economy is quickly recovering.** It had bottomed out in the second quarter, in response to unprecedented stimulus measures, both monetary and fiscal, but also because the previous decline of output had been unprecedented as well, at least in the post-war period. At some point replacement demand kicks in while depleted inventories must be restocked. **Real GDP growth in the present quarter will be in the order of annualized 3 per cent, or more. This explains the firmness of stock markets and commodities. Investors have become less risk averse.**
2. **At the same time, inflation is very low, mainly because output gaps are huge and because unemployment, a lagging indicator in the business cycle, continues to rise.** Competition has become so fierce in the course of the recession that firms have a hard time raising their selling prices, just as workers are generally in a weak negotiating position and have to be content with stagnating wages.
3. In global industry, the gap between what can be produced in normal times (“potential output”) and actual production is huge, somewhere between 11 and 14 per cent. This is in spite of China’s robust growth performance, and in spite of monthly increases of industrial production in the order of 1 to 2 per cent since last May. **In terms of global GDP the output gap is in the order of 7 per cent.** Goldman Sachs’ economists have estimated that America’s gap is currently 8 per cent, and might even be as large as 10 per cent (admittedly, potential output is a rather ambiguous concept and impossible to measure).
4. Since capacity utilization rates are the main determinants of inflation, it does not come as a surprise that price stability has almost arrived. **In the world’s four largest economies – the US, the euro area, Japan and China – which account for about 55 per cent of global output, year-on-year consumer price inflation rates are negative.** So far, only headline inflation has fallen below the zero line, but for core inflation, which excludes energy and seasonal food, the trend is also firmly in that direction. Note that in most countries producer prices are generally in deep deflation territory even though commodity prices have rebounded strongly since early 2009. There is a lot of deflation in the pipeline.
5. **Investors are not yet convinced that deflation is a genuine threat. In the euro area,** for instance, break-even inflation rates derived from inflation-linked bonds, a proxy for **inflation expectations, average about 1.5 per cent for the next five years, and 2 per cent for the coming ten years.** The public has yet to familiarize itself with the idea that price levels could fall for years on end, as they have in Japan. There, nominal GDP is presently no less than 7.1 per cent below its level twelve years ago, even though real GDP

is up 5.1 per cent. Deflation of about 1 per cent per year is by now well established. Investors are convinced that nothing of that sort will happen in the euro area.

6. **US 10-year Treasuries yield 3.5 per cent at this point whereas year-on-year headline inflation is -1.5 per cent; in the middle of a deep recession these securities carry an impressive real yield of 5 per cent.** This does not make much sense. The reason, of course, is that an inflation rate of -1.5 per cent is seen as an aberration; inflation-linked 10-year US Treasuries suggest that people expect inflation to average +1.9 per cent over the next decade, not least because the government deficit has reached war-like dimensions and will inevitably have to be inflated away. On this basis, the real “riskless” yield is only 1.5 per cent which appears to be about right (but the inflation expectations could be way off, I might add).
7. **Central banks are actually more worried about deflation than market participants.** This is because they are aware of the dimension of banks’ unresolved problems. Assets are in general not yet valued at true market prices. If they were, many banks would be insolvent, which is, after Lehman, a nightmarish notion. The Fed and the ECB will do whatever is necessary to prevent a repeat - systemically important banks will not be allowed to go under any more.
8. In OECD countries – but also in some important emerging economies such as Russia - the process of restoring the health of bank balance sheets is by no means completed. It is very time consuming.
9. So **central banks will keep their foot firmly on the accelerator.** They have communicated to market participants that the implementation of exit strategies is not a near-term issue. The priority is to restore the profitability and thus the capital base of banks. This is still an uphill struggle because the ratio of non-performing assets to total assets continues to rise and eat into profits. Just as unemployment, this ratio is a lagging indicator in the business cycle.
10. As long as inflation expectations remain in the comfort zone of, say, 1 to 2 per cent, nominal bond yields can be expected to be 3 per cent or higher. Since policy rates in the main economies are close to zero, **yield curves are fairly steep**, especially in the US but also in Britain and some euro area countries such as Italy, Greece or Ireland. The traditional maturity mismatch of borrowing short term and investing long term is therefore a profitable proposition for banks and other investors. It works as long as investors are not significantly revising down their inflation expectations, in other words: if we do not end up with a Japanese scenario.
11. For banks, there is now an additional difficulty: **regulators are pushing for much lower gearing ratios, ie thicker equity cushions.** On the one hand banks must therefore raise their capital base by issuing stocks, on the other hand they try to shrink their balance sheets and are tempted to get rid of some of their assets, or to become very selective in their lending. The effects are clearly visible. To give just two telling examples: in the euro area, loans to the private sector have declined for more than half a year by now, and in the US consumer credits are down 10.4 per cent from one year ago.
12. **Banks’ strategies are clearly pro-cyclical and thus act as a brake on the economic recovery:** without some growth in lending it will be hard to achieve a robust and self-sustaining expansion of the real economy. Since there is no appetite for introducing “bad

banks” – because this would lay open the true cost of the financial crisis – policy makers have opted for procrastination and a muddling-through strategy, aside from nationalizations and pumping thousands of billions of dollars into the financial system.

13. **The risk is not negligible that the latter will create, or has already created, new bubbles in equities and some commodities.** If these pop, as they must, this will add to the mountain of other unsolved problems and imbalances and possibly lead to a decade-long stagnation of output and a significant slowdown of trend GDP growth. The bubbles could also force policy makers outside of China to start tightening before robust economic health has been achieved – an unpleasant prospect.
14. **In the near-term, a rather strong recovery of global GDP is a near-certainty.** Emerging markets are probably expanding at an annualized rate of 7 per cent in the current third quarter while developed countries are growing at somewhat less than half that rate. Since all leading business cycle indicators point up, the new-found momentum could carry the world economy forward at similar rates until the middle of 2010. But even then, the output gap would hardly have shrunk (because potential GDP growth slows only gradually), implying that a near-term resurgence of inflation is unlikely.
15. **Why is the US economy rebounding?** Employment has been declining all the way through August (payrolls: -4.3 per cent y/y; -2.9 per cent 3-month saar), lending to households is steeply down, as mentioned above, and consumers remain overindebted and desperately try to improve their financial health by saving more. The 31% fall of average house prices since July 2006 has put a significant proportion of them into net negative equity and forces them to rebuild their wealth, ie to cut spending.
16. **The answer** may be as simple as this: the free fall of GDP, and purchases in general, could not go on for ever. Countervailing forces are: attractively low prices of assets such as houses and stocks, low interest rates, expansionary fiscal policies, replacement needs, positive cash flows in the business sector as capital spending has been cut to the bare minimum during the recession, the need to restock run-down inventories, the significant depreciation of the dollar, a revival of activity in Asia, and the slowing speed of the decline (the so-called accelerator principle).
17. **America’s animal spirits have visibly improved even though the level of sentiment indicators is still rather depressed.** Orders to the manufacturing industry have recovered (July, nominal: -23.2 per cent y/y, +14.3 per cent 3-month saar), retail sales have temporarily improved due to the government’s “cash-for-clunkers” program (incl. food services in August, nominal: -5.3 per cent y/y, +14.3 per cent 3-month saar), housing starts have bottomed out, net trade makes a positive contribution to growth, and aggressive government spending has filled some of the gap caused by weak private demand. These are not the only positive indicators.
18. It is normal that quarterly growth rates are very high after a long and deep recession. **Expected annualized rates of about 3 per cent are actually quite low for an early phase of a recovery** – they reflect the fact that the American consumer whose demand accounted for more than 70 percent of US GDP and 17 per cent of global GDP not long ago is not yet able to join the party.

19. **For investors in US assets, cyclical stocks and corporate bonds are the obvious near-term choices.** Since the flow of bullish signals for the economy – including higher monthly inflation rates - will probably continue for while, US Treasuries will underperform. While the Fed Funds rate will stay in the zero to 0.25 per cent range for at least another six months, quantitative easing policies will be scaled down in response to the improved economic outlook, if only for a while.
20. **The euro area is also in recovery mode.** At the current exchange rate its nominal GDP has been €8.96tr in Q2 (US: €9.59tr). For reasons not well understood, **the recession has been deeper than in the US, with the notable exception of the labor market.** I had thought that the absence of area-wide, as opposed to national asset bubbles would be an advantage, just like the fact that, apart from Germany, Belgium and Holland, the financial sector had sailed smoothly through the crisis.
21. **The underperformance must once again have been caused by the closer integration of euroland into global trade** – which, in volume terms, had fallen even more than global output; “in June, it was still 19 per cent below its peak in April 2008.” (from CPB, the Netherlands Bureau for Economic Policy Analysis, 26 August 2009).
22. As it is, **euro area real GDP in 2009 will be about 3.6 per cent lower than last year**, compared to America’s expected decline of 2.4 per cent. The unemployment rate has hit 9.5 per cent in July, up from a cyclical low of 7.2 per cent in March 2008. Even though the labor market has been relatively resilient in this recession, unemployment is still on the rise and is the major economic problem. On the other hand, it helps to keep inflation in check, together with the huge amount of spare capacity and the recent strength of the euro. Deflation is still a serious risk: in August, CPI was -0.2 per cent y/y while industrial producer prices were down 8.5 per cent from last year.
23. Because world trade is so extremely volatile, **the recovery of global GDP, led by Asian emerging markets, will actually disproportionately favor the euro area**, export-dependent Germany in particular. For several quarters Germany will grow faster than the rest of the currency union; I expect a 5 per cent annualized growth rate of real GDP in Q3. To be sure, growth starts from a more depressed level. Either way, it now appears that the output gap will shrink faster than in neighboring countries, boosting profits.
24. These had taken a big hit recently as lay-offs had been surprisingly moderate thanks to all sorts of government programs and sticky labor markets in general. **Even though Germany’s real GDP had shrunk 6.7 per cent from peak to trough, employment has declined by just 0.5 per cent so far – with predictable negative effects on productivity and profits. This process is now reversing and provides good support for stocks. To a lesser extent this also applies to the other countries of the region.**
25. **Euro area fiscal policies are fairly conservative.** Government deficits are in the order of output gaps rather than about two times as much as in the US or in Britain. Among the larger euro area economies, France and Spain are most aggressive in terms of deficit spending. This is not only reflected in the yield premium the two have to pay (26 and 54 basis points on 10-year government bonds over “Bunds”), but also in the considerably lower price-to-earnings ratios of their stock markets – this means, the cost of raising capital is higher than in Germany.

26. **How expansionary is the ECB?** The policy rate is 1 per cent and thus well above actual inflation of -0.2 per cent. Relative to medium and long-term inflation expectations (see paragraph 5 above) it appears appropriately low though. On the other hand, going by the so-called Taylor rule which takes into account the (very large) output gap and the difference between actual and target inflation of just below 2 per cent the refinancing rate should be negative. Since even thinking about such a possibility is an absolute taboo at the ECB, other strategies should be applied – but aren't. Quantitative easing can not play a significant role as long as there is no formal agreement about burden sharing in case the ECB loses money on the fixed income securities it buys.
27. **So its main strategy is to wait and see and hope that world trade together with the usual cyclical forces will pull the euro area out of recession.**
28. **Conservative economic policies may be the main reason why the euro has been so strong recently.** The swift deterioration of the balance on current account (to almost 1.5 per cent of GDP), which is in sharp contrast to the rapid improvement of America's trade deficit (from 6 to less than 3 per cent of GDP within just two years), and the poorer growth prospects would usually suggest a strong dollar. The old relationships may not be working any longer because the US is massively printing money, in this way monetizing a large chunk of government debt. While this has not yet impacted the inflation rate **investors are clearly reluctant to pick up even more dollar bills. There are no signs that the demand for dollars is about to strengthen. The euro will soon cost \$1.50 again.**
29. For European government bonds, all this is good news. But **the strong exchange rate may now begin to cast a spell over stock markets** – on the back of the economic recovery story these have rebounded by about 50 to 60 per cent from their March lows but are still 30 to 40 per cent below the highs of 2007. The near-term outlook for corporate earnings is positive because the coming increase in output can be achieved with a constant or even falling input of labor. While an appreciating euro reduces the cost of imported inputs, there is a limit to how long firms can compete successfully internationally if everybody else, including the Chinese, tries to let their currency depreciate.
30. **The question is whether world trade does indeed rebound in a sustainable way.** In volume and dollar terms, **Chinese imports have increased by almost 60 per cent since last January** and are now at 70 per cent of US and 61 percent of euro area imports. On present trends, China will surpass the US within less than a year as the world's second largest importer of goods. Since the country is growing so fast – 7.9 per cent year-on-year in Q2 – this is not as unlikely as it looks. America's and Europe's imports have also been rising in real terms since the dark days of Q1, but not by much, while Japan's are at best stable. **So China, together with some other Asian emerging markets, is world trade's growth engine.**
31. **Its massive stimulus programs seem to work so far.** The structural shift from export to domestic demand-driven growth is well under way. Explosive import growth is one sign of this, real retail sales growth rates in the order of 15 per cent y/y are another. It helps that consumers are in rude health, at least on average, because of record-high household savings rates. They still need to buy many things, and have the money to spend. The Chinese are about to buy more cars than Americans (the population is, of course, four times larger)! It also helps that government deficits have been small so far and can be financed comfortably.

32. **The main risk is that Chinese investors are creating new bubbles.** The Shanghai stock market trades at breathtaking multiples of 34 (4-quarter trailing) and 23 (estimated 2009 earnings), has gained already 68 per cent this year and has a dividend yield of only 1.3 per cent (Nikkei 1.8, DAX 3.6, S&P 500 2.4 per cent). Money supply M2 is up 28.5 per cent from a year ago but inflation is -1.2 per cent y/y. There must be plenty of surplus liquidity that finds its way into asset markets. The situation is not necessarily dangerous because households are certainly less exposed to debt than, until recently, the Americans, or the Japanese two decades ago. I wished I had some reliable statistics on Chinese real estate developments – because I don't, the picture is not as clear to me as I would like it to be..
33. **In Japan, meanwhile, imports are depressed** (-41 per cent y/y in May to July), as are retail sales (about -10 per cent y/y in January to July). Domestic demand is very weak. Even so, a recovery of real GDP is now under way, on the back of rebounding export demand (especially machinery), an end to inventory reductions, and public works. For the next few quarters, growth rates of about 2 per cent annualized look realistic. This means that spare capacities will hardly shrink. Not least for this reason, deflation remains firmly entrenched at about 2 per cent.
34. **On balance, Japan is a drag on the world economy.** Since the yen is once again appreciating against the dollar and is still rather firm against the euro (compared to 2007 / first half of 2008 levels) I do not expect a genuine export boom to develop, though. Foreign demand for Japanese products will not be exuberant but still rather solid, so stocks of exporters should do ok. Government bonds yield only 1.33 per cent in the 10-year range, but are quite a good bet given the strength of the yen, a zero policy rate of the BoJ, and inflation rates of -2 per cent and lower.
35. As mentioned, **commodities had a very good run this year but their prices remain well below those heady levels reached in the spring of last year.** These had been a major cause of the deep global recession, and then suffered heavily, ie more than proportionally, when the recession unfolded. Now they reflect near-term expectations that economic activity will improve for a while and that China's goods-driven expansion requires more and more raw materials and energy. As long as positive news on the real economy in major countries keeps coming in – which I expect – commodity prices are well supported. Longer term, the problems of American, Japanese, Spanish and British consumers, of banks worldwide and the need to tighten monetary and fiscal policies after recent expansionary excesses will put a lid on how much they can rise.
36. **Russia is a main beneficiary** of the new-found strength of oil, copper, nickel, steel, gold and the like. Currency reserves are rising again, as is the rouble exchange rate. It had dropped from 30 roubles per unit of the dollar / euro basket last November to 41 roubles in early February, and has by now bounced back to 36.75. The balance on current account has begun to show larger surpluses again ; even though the surplus had shrunk dramatically last winter it had never actually moved into the red. Along the same lines, the shortfall in government finances this year will be less severe, perhaps 7 per cent of GDP rather than the 8.5 percent that had previously been expected.
37. To be sure, the **recession has been deeper than in almost any country: the combination of collapsing commodity prices and the 36.7 per cent depreciation of the rouble had caused a massive terms of trade shock from which Russia has still not recovered:**

compared to one year ago, real wages are still down 5.8%, real retail sales 8.2 per cent, industrial production 12.6 per cent, and industrial producer prices 10.8 per cent.

38. Russian stock markets are very volatile, just as commodity markets. In spite of the 150 per cent gain since the depression low of last January the dollar-denominated RTS index is still 50 per cent below its all-time high of May 2008. **Foreign investors are only reluctantly returning after their recent traumatic experiences**, but the momentum is clearly building. As long as there is no reason to short commodities Russia may be a good place to invest. Some sectors are still very cheap.