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Investment Outlook

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1. The recovery continues, driven by the strong performance of Asian economies and expansionary public policies across advanced and most emerging countries. The IMF has just increased its **forecast for global real GDP growth by about half a percentage point to -1.1% in 2009 and +3.1% in 2010.** Commodity prices are thus well supported; I think they are only sustainable, though, if output growth keeps accelerating. The same holds for stock markets most of which are now discounting very high rates of corporate earnings growth for years to come.

2. Meanwhile, **resource utilization remains depressed**, reflecting the unusual depth of the recession that has just ended. If real GDP does indeed expand by 3.1% next year, the output gap would increase further, given that pre-recession growth has been in the order of 4 ½%. Disinflation has therefore not yet come to an end. Interest rates may be raised in some commodity exporting countries such as Australia and Norway, but in general neither fiscal nor monetary policies are about to be reversed. **Government bond markets are thus doing well, in spite of record high budget deficits.**

3. **The risk appetite of investors has visibly increased**, as evidence accumulates that growth has become fairly robust. Spreads of corporate and emerging market bonds over "risk free" bonds are not quite back to normal, but they have reached pre-Lehman Brothers levels again, and seem to fall further. Even so, it is not a foregone conclusion that the present recovery will indeed lead to a self-sustaining economic expansion. There are plenty of stumbling blocks that have the potential to derail the process.

4. For investors the main **question at this point is whether the expansionary forces – the reversal of the inventory cycle, pent-up demand, low interest rates, fiscal stimuli - are strong enough to compensate for the powerful forces that pull in the opposite direction**. One of them is the deleveraging strategies of households in countries and regions such as the US, Britain, Spain or Central and Eastern Europe where collapsing real estate prices and/or exchange rates have pushed many households financially under water. It forces them to cut back on consumption. Another one is the weakness of capital spending caused by low rates of capacity utilization, frequently combined with financing constraints.

5. A third **stumbling block is the situation of banks**. They still need to write off hundreds of billions of euros and dollars before their balance sheets can be considered to be healthy again. In spite of the massive expansion of base money, bank lending in the US, the euro area and Japan fails to catch on. Can the global recovery really gain momentum without a significant pick-up in borrowing? And what happens if fiscal policies must be tightened one day? After all, budget deficits can not rise forever. Or what, if central banks run out of

ammunition? They will not cut rates below zero (I think they can, but that is another matter).

6. Let me start with the **main conclusions of this Investment Outlook**:

    - **In the near term, positive signals from the real side of the economy will prevail**; but some countries are still struggling, especially the Baltics, Greece, Ireland and Spain; at the other end of the range are China, India and the other newly industrialized Asian economies which are expanding briskly. Their combined weight in global GDP now exceeds America's (says the IMF). Overall, annualized real GDP growth is presently in the order of 3 to 4%. The volume of exports and world trade has begun to expand at about twice these rates (their 2009 averages are still down about 12% from 2008!).
    - Output gaps remain very large – in the near term, **deflation is thus more of a risk than inflation.**
    - One important imbalance, the US savings shortfall, reflected in huge balance on current account deficits, is rapidly disappearing, but **new imbalances** are emerging, such as China's rising trade surplus, record government budget deficits almost everywhere, and, perhaps, overvalued stock and commodity markets.
    - Since **China and India** are pegging their currencies to the dollar, they are pursuing extremely expansionary monetary policies which will probably result in **new asset price bubbles**. As long as these don't burst, emerging Asia remains the world's growth engine (German exports to the region have expanded at an annualized rate of almost 50% over the past six months!).
    - The burden of the **inevitable dollar depreciation** is carried by those currencies which are floating freely: the euro, the yen and the Swiss franc.
    - In the medium term, **global growth will be slower than it used to be**, caused by deleveraging and subdued credit growth in important advanced countries; the world economy's center of gravity thus moves to East Asia at a faster pace than had previously been expected.

7. Following is a more detailed analysis. As usual, the **starting point is the American economy**, still the world's largest. It is once again living up to its reputation of resilience and flexibility. Real GDP has responded to the massive dose of fiscal and monetary medication. After shrinking four quarters in a row it has begun to expand again, probably at a rate in the order of 3 ½% annualized in Q3. For 2010, the IMF predicts an average year-on-year growth rate of 1.5%.

8. This is, of course, considerably less than the trend growth rate of somewhat more than 3%. **Unemployment will therefore continue to rise** and soon reach 10% of the labor force. For the foreseeable future, households will be unable to resume their profligate spending habits. With house prices still down about 30% from their 2006 peak and mortgages frequently 100% of the purchase price, many consumers are forced to give debt reduction top priority. Even if they tried to borrow more, banks would not readily lend to them - they are not only keen to improve the quality of their assets but are also trying to shrink them in order to improve balance sheet ratios.

9. **The drivers of the US recovery are, apart from the inventory cycle, government spending and exports.** The budget deficit will reach 12% of GDP this year and is thus exerting a massive stimulus, given that real GDP is “only” about 8% below trend. Exports benefit from the weakness of domestic demand, from the large output gap and the depreciation of the dollar.

10. It is somewhat of a **puzzle that the dollar is so weak**. Unusually, the swing in America’s balance on current account from a deficit of 6% of GDP not long ago to a deficit of less than 3% has not impressed foreign exchange markets. The dollar seems to have become a borrowing currency in carry trades (where speculators invest in higher-yielding currencies) because the Fed does not tire to assure the public that it will keep the policy rate close to zero well into 2010. This causes some selling pressure. Moreover, institutional investors and anybody who has some background in economics must be aware that **US money printing presses are spinning fast**: something that is as plentiful as the dollar must lose its value. If there were not so many countries which are pegging their currencies to the US currency, it would already have depreciated a lot more. In any case, in the near term this weakness is rather welcome from a US perspective: it stabilizes growth and employment – while inflation is still considerably below policy makers’ comfort levels.

11. It is also **not self-evident why US government bond yields are so low** (5 years at 2.28%, 10 years at 3.33%). The prospect of exploding government debt (forecast to reach 100% of GDP within five years, like in times of war) and the weak dollar could be a recipe for much higher yields. The key point is low inflation. There is so much slack in the economy that it is almost impossible to raise prices. In spite of the commodity price rebound and the dollar depreciation industrial producer prices are 4 ½% lower than one year ago! As always, wage inflation has come down only gradually during the recession – wages are “sticky” – but this is now changing, contributing to the disinflation process. If so-called discouraged workers are included, ie those who have given up hope that they will ever find a job again, the unemployment rate would already exceed 15%. Workers have no negotiating power whatsoever**. Inflation will not accelerate as long as wages are decelerating. Bond markets are the beneficiaries. They also benefit from the fact that the Fed Funds rate will remain just above zero for quite a long time.**

12. **Why are American stock markets so buoyant?** On the basis of this year’s estimated earnings the price-to-earnings ratio of the broad S&P 500 index is no less than 18 - which translates into an earnings yield of 5.6% and compares to a real yield on 10-year Treasuries of 4.6% if the current consumer price inflation rate of -1.3% y/y is subtracted from the nominal yield. This means the **equity risk premium is extraordinarily low**. It reflects the expectation that corporate earnings will rise strongly for an extended period of time.

13. Steep earnings increases in the early stages of a recovery are normal – because productivity gains tend to be large – but to extrapolate them can only be justified if GDP growth accelerates significantly and then stays high. Deleveraging consumers, cautious banks, rising unemployment, the coming withdrawal of the fiscal stimulus, perhaps a secular decline of potential GDP growth (following the Japanese role model) make such an outcome rather unlikely. **Stocks are too expensive. The fact that average dividend yields are just 1.2% supports this view.**

14. **The euro area has been rebounding in Q3 at a rate similar to America’s**. Here the main drivers are government and household consumption. Capital spending remains depressed,

but it now seems that net exports are not declining any more – going by Germany's foreign orders and exports – and that inventories have stabilized. According to the IMF, real GDP will still decline by an unprecedented average of 4.3% y/y in 2009, followed by a meager 0.3% expansion in 2010.

15. **Even though the currency union has been spared a real estate crash of US proportions** – because Spain and Ireland where this happened account for just 10 per cent of its GDP – **the recession has been worse** and the predicted recovery slower than in America. The main reasons are Europe's greater dependence on exports and world trade and the relatively muted reaction of fiscal policies to the crisis.

16. As mentioned before, in 2009 the volume of global trade will be about 12% less than last year. The situation is exacerbated for the euro area by the **relentless rise of the real euro exchange rate against dollar, sterling as well as against east European and all those currencies which are pegged to the dollar.** Since China, India and Russia, among other emerging economies, continue to intervene, the depreciation of the dollar will mostly be against the euro which is now once again well on its way to the previous peak of almost $1.60. The comparatively high ECB policy rate of 1% prevents the euro from becoming a funding currency in international carry trades, which is an additional source of strength.

17. With regard to **fiscal policies**, the euro area's actual government deficit is significantly smaller than America's this year: 6.2% of GDP versus 12.5% (IMF estimates). This is in spite of the steeper decline of GDP. The Stability and Growth Pact which sets the rules for fiscal policies restrains the 16 member countries in a crisis like this one. Countries are less autonomous than before joining the currency union, and less autonomous than, for instance, the US or the UK.

18. The open economy of the **euro area now benefits from the rebound of world trade** which, according to the IMF, will expand by an average of 2.5% y/y in 2010, and by much more on a quarter-to-quarter basis. Such a big swing is a compensation for the appreciation of the euro. A second supporting factor for the economy next year will be the further increase in the fiscal deficit to 6.6% of GDP (America's is forecast to shrink to 10.0%).

19. If I look at the strong growth of Germany's incoming orders to the manufacturing industry over the past six months (+37.2% seas. adj. annualized) and the brisk rise of sentiment indicators **I have my doubts that the euro area will indeed underperform the US** so significantly from here on. Another growth-supporting argument is employment: for various institutional reasons, euro area lay-offs have been rather moderate, and significantly less than in the US. Households are still financially sound and are not forced to increase their savings rate in order get out of some debt trap, at least on average. In other words, **real GDP growth will be at least one percentage point higher than those 0.3% predicted by the IMF.**

20. **A full-scale run on the dollar would be a major risk.** European politicians are already getting increasingly nervous about the exchange rate. The ECB sounds rather alarmed as well, given that the economic recovery is not yet firmly established, and may soon be forced to do something. Before it starts to intervene (buy dollars) it will use its option to cut the refinancing rate to close to zero. I guess the critical point is reached once the euro touches $1.60. For the time being, tough statements, or verbal interventions, will have to do, though.

21. Inflation is not raising its head again if the scenario outlined above is about right: the output gap is still extremely large, unemployment will probably rise for some time, and the exchange rate is super strong. Industrial producer prices are down 7.5% from a year ago. Even a significant increase in commodity prices would not change the picture decisively. It helps that the ECB is rather skeptical about the sustainability of the recovery and will not consider tightening the reins any time soon: banks' credit portfolios continue to deteriorate and the state of the banking sector remains precarious. The room for maneuver is very limited. **Government bond yields, presently 3.23% for German, 4.08% for Italian 10-years, have thus not yet bottomed out; the trigger for the next leg down will be rate cuts, aimed at stopping the euro from rising.**

22. **Euro area stock markets** trade in a p/e range of 13 ½ (France, EuroStoxx50) to 16 ½ (Germany) on estimated 2009 earnings. The dividend yield is presently no less than 4.0%. These are more reasonable valuations than in the US, but they also reflect the expectation that the economic recovery is on track. The main risks are that lending continues to stall because banks are still struggling with their bad assets, that governments prematurely decide it is time for an exit from (moderately) expansionary policies, that the global economy begins to stutter again and, of course, a foreign exchange crisis. On the other hand, European stock prices are still 28% (DAX) and 36% to 37% (EuroStoxx50 and CAC40) below their previous peaks. **Risks and rewards are reasonably well balanced, it seems to me.**

23. After more than a decade, **Japan is still stuck in deflation**. The IMF expects consumer prices to decline by another 0.8% y/y in 2010; the analysts of JPMorgan believe the inflation rate will actually be more like -1.9% y/y. Deflation is no longer a catastrophe, though; once market participants have adjusted their expectations it is compatible with positive output growth. According to the IMF, real GDP is forecast to expand by 1.7% next year, after a decline of 5.4% y/y in 2009.

24. As in Germany, the new **expansion began already in the second quarter**, driven by a huge increase of public investment and a fairly brisk expansion of government consumption. Since nominal bond yields (now 1.34% for 10 years) hardly budge, no matter how high the deficits, policy makers are not afraid of adding further debt. In 2010, gross debt will hit 227% of GDP (Germany: 85%, US: 94% - all according to the IMF). But the **main swing factor in the present economic rebound has been exports**, mostly to emerging Asia, which are increasing at annualized rates of about 30%, after the 64% collapse in the first quarter. Not only that, imports are expanding only very modestly because domestic demand remains in the doldrums. The result is that net trade has been making a strong contribution to growth.

25. **Japan's economy is clearly very competitive**. Today's exchange rate to the dollar of 90.7 yen does not pose any big problems: taking into account inflation differentials since April 1995, the previous high, generates a comparable exchange rate of less than 60 yen to the dollar. Such a level is a long way off. Another aspect is that there is a lot of slack in the economy which enables exporters to deliver very promptly. It also seems that Japan manages structural change very well and is successful in defending its place at the top of the global value added chain. The country used to have the right products for American and European consumers, it now has the products that can successfully be sold into neighboring Asia, especially capital goods.

26. The stock market is still 73% below the end-1989 high, 43 % below the most recent high of July 2007 (just before the beginning of the global financial crisis), but in the meantime up 47% from the March 2009 low. **Firms are making money again** and pay a dividend of 1.5% on today's stock market valuation, ie more than the government pays on its debt. This is attractive considering that dividends are usually rising after the end of a recession. Average price-to earnings ratios are elevated, as usual, which means investors must focus not on the index but on sectors that can be expected to do well, such as exporters and providers of infrastructure. **Japanese bonds are not as expensive as they look at first glance: in real terms they are about the best one can get, while the likely further appreciation of the yen provides an additional kicker.**

27. **For the world economy as a whole, China plays a crucial role now**. With a population four times that of the US and ten times that of Japan, a share in global GDP of some 8.0% (US 24.7%, euro area 23.4%, Japan 9.1%, Russia 2.3%) at the current exchange rate and of 11.4% in purchasing power terms, its economic development has to be monitored closely. Especially for commodity markets, China's rate of growth as well as the structure of the growth rate is decisive. It is not an exaggeration to state that China has replaced the US as the world's engine of growth.

28. The IMF predicts that its **real GDP will exceed last year's by 8.5%.** Since, according to my estimates, nominal GDP will be up just 4% y/y in 2009, the GDP deflator will average -4.1% y/y. This makes for a combination of record growth (not by Chinese standards, though) and near-record deflation. The latter probably reflects a low rate of capacity utilization: gross fixed capital formation has outpaced real GDP in nine of the last ten years; in 2009, it will be up 14.8% y/y in real terms. It accounts for 42.0% of GDP this year which is about twice as high a number than in the US or the euro area. In other words, the capital stock continues to grow so rapidly that demand cannot catch up. While consumer demand and government spending are expanding briskly, foreign demand has weakened considerably – exports will probably decline by 20% year-on-year in 2009 (this is in nominal terms, in real terms the decline will be even larger). In such an environment, firms have a hard time raising prices.

29. **China is once again trying to promote exports in order to improve the rate of capacity utilization and boost employment.** For more than a year, the yuan has successfully been pegged to the dollar at a rate of 6.83. Because the demand for the Chinese currency is so strong, foreign exchange reserves are once again exploding; by now they have reached $2.3tr which is more than twice the amount Japan has accumulated.

30. **This export promotion is highly risky from a global point of view**. The US and the UK are trying to increase their savings rate by importing less and exporting more, Japan and Germany bank on exports to pull their economies out of the recession, for most east European countries exports are the only way to reduce their foreign currency debt – it simply does not add up. Someone must be willing to absorb all these exports. Not everyone can be an exporter – the guys from Mars have not yet signaled that they stand by to become the importers of last resort.

31. Chinese domestic demand expands already at rates well above that of overall GDP, but it must accelerate even more to keep everybody busy. **Private consumption accounts for just 36.1% of GDP, half the rate America used to have.** The country is still extremely poor and has thus a huge potential for spending on consumer goods. In view of a national

savings rate of almost 50% there is no risk whatsoever that a consumer boom cannot be financed. For reasons I do not understand the Chinese government relies once again on foreign trade and thus a strategy which is doomed to fail. It is obviously afraid to let the yuan float, ie stop interventions, because the appreciation might become so large that export demand would collapse. The necessary structural changes inside China would simply not be manageable. Deflation would also deepen further.

32. **Another development that may not have a happy outcome is the simultaneity of explosively expanding money and credit**, presently in the order of 30 to 35% y/y, and a declining general price level. Where is all this liquidity to go? By now, we know the answer quite well – there will be asset price bubbles! Stock markets are booming once again. They are up 81% from the recent low in November 2008. While they are still about 50% below the peak of October 2007, they are well on their way back to those levels, and beyond. Compared to what we have seen in Japan in the late eighties – average p/e ratios in the order of 80 - valuations are still modest; based on estimates for 2009, the multiple for the Shanghai market is “only” 22.8. We have no meaningful data on real estate prices, but it would not come as a surprise if they would be taking off as well.

33. **Even so, China may only be in the early stages of new asset price bubbles.** In the case of Japan, prices really took off once capital accounts were fully liberalized in the eighties. There is a lot of money that craves to be invested in China, and it would come flooding in the moment the gates are flung open. Since the yuan would appreciate for a long time, investments in China would be seen as one-way bets. Low inflation rates, sound public finances, current account surpluses, high growth rates, very low interest rates (perhaps, via swaps, even negative ones) would be other positive ingredients. If China does indeed follow Japan’s route – so far it has – investors can do little wrong by hooking onto the story of the next decade, or, as it may become, to the mother of all bubbles. The challenge is to get out in time. This has rarely worked, as we have learned.

34. For the foreseeable future, China will be the driver of **commodity markets**, including oil. Prices have nicely recovered from their lows early this year but are still far away from top levels reached in the spring of 2008. In the wake of China, the world economy is expanding moderately to briskly, especially manufacturing activity is back with a vengeance. How long this can last is another question – I assume that there is not much underlying and lasting strength in a global recovery that lacks the demand of American consumers and sound banks. Moreover, stimulative fiscal and monetary policies can only be effective for a while.

35. **But I also know that it usually pays not to go against the market, suggesting that commodity prices will probably rise some more.** Industrial metals such as aluminum, nickel or copper have gained between 45% and 127% since the days when the global economic situation was bleakest, ie not long ago. On the other hand, prices are still well below previous bubbly highs: aluminum by 40%, nickel by 63%, copper by 25%. Keep in mind that the global economy is not expected to do as well as back in the spring of 2008, so the upside potential is more limited than back then. Moreover, inventories are well filled, and price levels are once again between 100% and 300% above those prevailing in the twenty-year period before 2004, the year when the commodity price bubble began took off.

36. **Oil prices have also been driven to the skies recently.** Today, a barrel of West Texas Intermediate costs $79.60 and thus 153% more than last December. Bullish analysts will argue that this is still 45% below the level reached in July 2008. For thrm, it has to move

back there, or higher, because the long term trend of oil demand is up (just think China) and there is only a finite supply. I would argue that the average oil price in the twenty years before 2004 has been just $22, and fairly stable around this level most of the time – why should it now be 260% higher? Global real GDP has grown strongly since, but not by more than 17.4% (2004 to 2009). Such a discrepancy does not make sense. Further, oil prices as high as today will trigger all sorts of reactions: savings, substitution, more exploration. Market forces work. **The time has come to buy oil puts again.**

37. **The gold price is another puzzle.** Yes, it reacts positively to falling interest rates, and to some extent it makes up for the depreciation of the dollar. But this does not explain why it has risen fairly steadily from its last low in August 1999 of $254. Since then it has gained on average 15.0% a year. Gold is supposed to be an important hedge against inflation – but inflation expectations continue to fall, as evidenced by the decline of government bond yields in the face of ballooning government deficits. Gold is also an asset of choice in times of political uncertainty? As far as I can see, the world is not a riskier place than it used to be, to the contrary, global per capita incomes have never been so high, both on the basis of medians and arithmetic means. **I suggest to short gold – but this would be very much against strong market momentum.**

38. Finally, some words about **the investment environment in Russia**. The country is the main producer and exporter of commodities, including energy, and thus benefits greatly from the reversal of their prices. As a result, the rouble has appreciated from almost 41 units to the dollar-euro basket (0.55 rouble per $ + 0.45 rouble per €) in February 2009 to 35.66 units today, as the trade surplus and with it the demand for rouble have bounced back. One side effect of this new-found strength is the string of positive surprises from the inflation front, even though consumer prices are still 10.7% higher than a year ago. Foreign exchange reserves which the central bank reports on a weekly basis have increased by more than $40bn since the low in March and have reached a comfortable $419bn. The trade surplus will be 2 ½% of GDP this year.

39. Russia has gone through a very difficult period of time and is still only at the early stages of a recovery. **The IMF estimates that real GDP has fallen by 7.5% from 2008 – and will only gain 1 ½% in 2010** which is far below the new medium-term growth rate of 4% to 5%. After eight years with average growth rates of 6 ½% the sudden decline of commodity prices had caused a deep recession.

40. The economic term for what has happened is **"terms of trade shock".** In the years since 2004, when commodity prices began to take off, real disposable income and real wages had increased by five or six percentage points a year more than real GDP. Export prices rose much faster than import prices which means the Russian population could spend more than it produced. This caused a general euphoria, not only among consumers but also in business. When export prices suddenly collapse, the process goes into reverse – household incomes and corporate profits increase by less than GDP. As it was, both GDP and national income declined, the latter by much more than the former, beginning in late spring 2009. In dollar terms nominal GDP shrank by about 22% between 2008 and 2009. To be sure, even at this depressed level it was more than twice as high than in 2004, five years ago.

41. The **Russian banking sector** was not only faced with a steep rise in non-performing loans, it also was trapped by its borrowings in euro and dollar - a rouble depreciation had not been regarded as a genuine risk which made borrowing at lower foreign interest rates a very profitable proposition for some years. This strategy was based on the, in retrospect, naïve

assumption that commodity prices were on a one-way street. It was all wishful thinking: between November 2008 and February 2009 the rouble fell by no less than 35% against its dual-currency basket. In rouble terms, foreign currency-denominated debt almost exploded and banks were mostly unable to lend, at a time when funding needs were greatest. These were the recipes for the deep recession that is only now coming to an end.

42. **Banks and large corporations are gradually recovering**. The strength of commodity prices is a god-sent – the terms of trade are moving in Russia's favor and strengthen the purchasing power of consumers, if only at the margin. Real incomes are still less than a year ago, and unemployment, at 7.6% is 1.4 percentage points higher; seasonally adjusted it seems to come down, though. All this makes the job of repairing balance sheets easier than expected. It helps that households are not overindebted (for the simple reason that the market for mortgages is still in its infancy).

43. But it is still a long haul. **Financial conditions will remain tight**, not only because it takes time to clear bad debts from domestic banks' loan books but also because access to external capital markets has been impaired. Under these circumstances there will be no quick return to those 6 ½% growth rates of real GDP. Another element holding back medium term growth is the fact that the government will likely continue to favor social spending at the expense of infrastructure programs – this slows productivity growth.

44. **The crisis has been a reminder that the Russian economy must be put on a broader base**. A large country should not be hostage to volatile commodity markets, or succumb to the so-called Dutch disease where large revenues from commodity exports lead not only to an appreciation but an overvaluation of the real exchange rate which in turn makes domestic production of non-commodities uncompetitive. Import-competing industries close down as a result - and may never come back. The government is quite aware of these problems but can not do much in the near term: this year the budget deficit will be no less than 8% of GDP.

45. **The stock market has responded enthusiastically to the recovery of the global economy and commodity prices and the improvement of the economic outlook for Russia.** In spite of the recent rally, the main index still trades 42% below its all-time high of May 2008. But it is not really cheap at a p/e ratio of 13, based on 2009 earnings estimates. Analysts expect that profits will rise briskly (about 40%) between this year and next which may be realistic, provided that commodity prices hold up; a large further increase of energy and metals prices is generally not among the key assumptions. We presently favor the electricity sector where the reform process is picking up speed again.

46. As to **Russian sovereign and corporate bonds**, the return of risk appetite, lower inflation rates and the likely further appreciation of the rouble make for an attractive mix. It helps that the central bank will probably continue to ease gradually. In the wake of exchange market interventions the liquidity situation will improve further; right now money supply M2 is still 8.4% below last year's level. It can only get better.