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Investment Outlook

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1. **Economic news continues to be mostly good.** Global output growth has rebounded briskly since last spring, especially in industry. Inventory depletion has been followed by restocking as final demand has bottomed out, while fiscal and monetary policy makers do not yet intend to take away the punch bowls.
2. At the same time, though, it is **no longer possible to provide additional policy stimulus.** We are thus approaching a critical point where the global economy must shake off life support lines and achieve the transition to a self-sustaining expansion. It is now consensus among analysts that such a transition is likely. World real GDP is expected to grow at rates of 3 to 4% well into 2010 which explains the strength of stock markets and commodities. In spite of the cyclical recovery, producer and consumer price inflation rates will remain very low, though - there is still a huge amount of slack globally.
3. So **bonds** are generally well supported by the benign inflation outlook and accommodative monetary policies. **Equities** are also doing well in an environment of brisk growth, a recovery of productivity and low interest rates - but are no longer cheap. The same holds for **corporate bonds**: abundant liquidity, the almost desperate search for yield by institutional investors and the ongoing decline of risk aversion have driven down spreads to pre-Lehman levels. **Commodity prices** benefit from cheap money, the rebound of global GDP and the fear of investors that aggressive money printing may end in tears for financial, as opposed to real, assets.
4. **Risks have not gone away. There is still the danger of a Japanese-style deleveraging process that ends, via negative feedback loops between the banking industry and the real economy, in deflation and much-reduced secular GDP growth. Another possibility is run-away, Brazilian-style inflation and a debauching of currencies, caused by huge government deficits and, in their wake, aggressive money printing. The two outcomes look incompatible, but both are nevertheless plausible. The investor community is torn between them: record low nominal bond yields reflect a widespread fear of deflation while buoyant stock markets and commodity prices suggest a flight to real, ie inflation protected assets and a distrust of fiat money.**
5. **Top of the list of risks is the health of the banking industry.** In October the IMF estimated that additional global bank write-downs on loans and securities were in the order of \$1.5tr, on total holdings of \$55.7tr. (Global Financial Stability Report, Oct. 2009, pp. 9 & 10). Total write-downs between 2007 and 2010 are estimated to be \$2.8tr which translates into a so-called loss rate of 5.0%. Had allowances for bad assets been made at

one fell swoop, rather than gradually, the equity base of the global banking sector would have been wiped out.

6. In the US where the overall loss rate is expected to reach 8.2% (of holdings), the key problems are in mortgage and consumer related assets whereas euro area banks, with a loss rate of “only 3.6%”, are mainly struggling with foreign, ie central and east European loans and securities. The situation is similar in the UK (loss rate. 7.2%). According to the IMF, Asian banks (ex those of important emerging economies such as China and India) have a loss ratio of just 2.1% and are thus relatively sound.
7. These numbers imply that **American and European banks are still in the process of recapitalization and need several years of strong earnings before they will be back in good health.** Because banks make much of their money by borrowing short-term and lending longer-term, yield curves have to remain steep (which makes it difficult for central banks to reverse course).
8. Banks will continue to have an incentive to get rid of risky and underperforming assets. In spite of ample liquidity, lending in the OECD area and in some emerging economies is thus either stagnating or falling. Banks prefer to use cheap money from central banks to buy government bonds, a sort of carry trade. Large firms can switch to the corporate bond market or raise equity, but small and medium-sized firms as well as consumers will be left stranded. **As we have seen in Japan, without a healthy banking sector it is extremely difficult to achieve robust economic growth.**
9. **Another major risk that may derail the global economic recovery is the weakness of US personal consumption.** To provide a perspective: at \$9.3tr a year it is about 16% of world GDP (of \$57.2tr) and 128% of China’s and India’s combined GDP (at current exchange rates). For many years American consumers had been the drivers of world demand. No longer. Since early 2008 their spending is actually on a slight downtrend. Who will be able to fill the gap?
10. **One reason for the weakness in US personal spending is unemployment:** it has doubled over the past two years to 15.7m, or 10.2% of the labor force. Weekly initial jobless claims in the order of 500,000 suggest that the number of jobs is still declining, if not so fast anymore. Employment will only stabilize once the number of claims reaches 400,000 or less. In a recovery this may happen quicker than expected, but right now claims are rather sticky in the half a million neighborhood. Because capacity utilization rates are still depressed firms can easily accommodate rising demand for their products by pushing productivity. Another problem is the fact that state and local governments – most of which are legally bound to balance their budgets – are under growing financial pressure and thus unable to start hiring again.
11. Before the crisis, it used to be conventional wisdom that because of the steady increase of the labor force the US needed something like 140,000 new jobs every month just to keep the unemployment rate unchanged – the latest payroll number was -190,000! In other words, it very much **looks like a jobless recovery so far.**
12. In addition, the average **value of consumers’ main asset – their home – has fallen by no less than 29.3% from its all-time high in mid-2006, putting many households financially under water.** The Mortgage Bankers Association has just reported that “more than one in seven US borrowers were behind in their mortgage payments or facing

foreclosure at the end of the third quarter – the highest on record – as rising unemployment continued to fan the flames of the housing crisis.”

13. Even more American households have been **forced to stop taking out mortgages to boost their living standards**; for a long time, the working hypothesis had been that rising real estate prices could be a substitute for genuine savings. Real estate prices always rise, don't they?! It was nice as long as it lasted. In the end, consumer debt in percent of GDP was considerably larger than before the start of the Great Depression of the thirties. The chickens have now come home to roost – debt reduction is the order of the day. Because of record low mortgage rates and low prices buying a house has rarely been as affordable as today – but few are able to take advantage of this. Housing starts continue to languish at about half a million per year and thus at three quarters below the levels of early 2006.
14. This implies that **US consumption will remain weak which in turn lets me doubt that the transition to a self-sustaining expansion is imminent**. Supposedly, policy support can not be withdrawn yet. Since headline consumer price and producer price inflation rates are still in negative territory (-0.2% y/y and -1.9% y/y, in October) there is no pressure to tighten the reins, ie raise interest rates from near-zero and reverse quantitative easing.
15. It is also **of strategic importance - for the US and the rest of the world - that the dollar continues to depreciate**. Net exports have to fill some of the demand gap created by weak personal consumption. To be sure, for the global economy the near-term impact of the long-overdue reduction of America's external imbalance is rather negative. All countries want to be like Japan, Germany and China these days, by trying to export their way out of the recession. It will not work.
16. **A third major risk has to do with the extraordinary growth of central bank money and record-low interest rates**. Are we witnessing the creation of new asset price bubbles? Governments do not want banks to deleverage right now because asset sales and a curtailment of credit would deepen the recession. They actually aim for rising asset prices again. Better bubbles than running the risk of a depression. But what if we do get new bubbles and these then pop as well, as they inevitably must? Policy makers won't be able to clean up the additional debris that can be expected when this happens - the room for manoeuvre has been used to the full already, and the tools are blunt by now.
17. The balance sheet of the Fed has lengthened by 150% since early 2007 while the ECB's has increased by about 50%. In spite of this, bank lending and money supply are still extremely subdued. In the present environment of wide-spread deleveraging, **the monetary transmission mechanism does not work, or has changed**. Some of the additional central bank money ends up in bonds, another part is deposited at central banks again or is used to buy money market instruments issued by governments, at interest rates close to zero.
18. **In the euro area, the key central bank rate is presently the rate banks get on their deposits at the ECB – 0.25% since April 8 - rather than the 1% rate on the main refinancing operation**. Banks borrow at 1% from the ECB, but do not have an immediate use of the funds and are thus forced to turn around and deposit a major part of them at 0.25% at the ECB again. In the interbank market, they get only 0.3% overnight, because there is so much liquidity, and if they invest in 3-month (German government) BuBills they can only earn an equally meager 0.42%.

19. Lending simply does not pick up, despite all the efforts, which means that the **risk of dangerous stock market or real estate bubbles is rather small in Europe**. When asset prices rise strongly, but investors use their own rather than borrowed money, the eventual bursting of bubbles must not be a financial catastrophe. In any case, neither stock markets nor real estate markets are particularly expensive. The price-to-earnings ratio based on earnings estimates for 2009 is 15.8 for the German DAX, 13.0 for the French CAC40, and 13.2 for the EuroStoxx50. According to ECB statistics, neither input prices for construction nor residential property prices are rising. A new property bubble is also a very remote risk.
20. **The ECB is “pushing on a string”**, at least for now. Firms are operating at low rates of capacity utilization (real GDP will be -4% y/y in 2009). Their main concern is to increase profits again and they will therefore invest mostly to reduce costs rather than to expand operations. Much additional debt is not required for such a strategy. As to households, they are traditionally cautious: looking at the precarious state of the labor market they prefer to remain financially independent. Overall, the demand for credit will therefore stay weak. On the supply side of credit, the health of banks has not been restored yet; they are forced to deleverage, ie reduce their borrowing, and are therefore not too keen on lending.
21. **The risk that the fairly strong growth of European base money will spill over into rising core consumer price inflation or asset prices is non-existent**, given low rates of capacity utilization, moderate GDP growth (about 2% annualized from here on), rising unemployment (9.7% in September) and an appreciating currency. The ECB intends to withdraw liquidity after the December auction (1% fixed, unlimited amount, for one year). Rising headline inflation rates from November onwards will come in handy to justify the move. But these will simply be the result of an energy-related base effect. Underlying inflation, ie ex unprocessed food and energy, will not rise and be in the order of 0.8% throughout next year. Euro area producer price inflation has been -3.5% y/y in September, while German import prices were down 10.8% y/y. Looks like deflation, doesn't it? In other words, the ECB will have to leave it at cosmetics for quite a while.
22. **It is also quite unlikely that there will be new asset bubbles in the US, or in the UK**. Some analysts continue to calculate American M3 after the Fed has stopped publishing the series – on a 3m/3m annualized basis its rate of growth has been -7.8% in October!! Bank balance sheets are still contracting: deleveraging has priority. Here again – no leverage, no dangerous asset bubbles, if any. Housing, meanwhile, is recovering but remains depressed. The Fed is in no position to raise interest rates or discontinue quantitative easing. This is a main reason why Treasuries, in spite of the weak dollar, have been so strong lately.
23. **How about Japan? Policy makers there would love to see some asset bubbles again**. Deflation has returned (CPI was -2.2% y/y in October), consumption is flat, and the job market stagnates. The Nikkei 225 stock index has gained only 7.2% this year, much less than any other of the major markets, and remains 76% below the level reached at the end of 1989 (nineteen eighty nine!). Going by the monetary base which shrank at an annualized rate of 4.8% in the six months to October there is no chance of asset bubbles developing.
24. **This leaves those countries where money supply aggregates are expanding rapidly, plus commodity markets**. The main, and usual, suspect is China. Some other emerging markets also qualify. Their common denominator is the strategy to peg their currencies to the dollar or, more precisely, to prevent them from appreciating against the dollar. In this way they try to maintain their international price competitiveness. So they buy, without a

quantitative limit, dollars at a fixed rate – 6.83 yuan per dollar in the case of China – and thus create domestic currency deposits which in turn boosts money supply.

25. **These central banks have thus given up control over central bank money and money supply in general.** They might issue money market instruments to “sterilize” (mop up) some of the unwanted liquidity, but usually don’t because this would drive up interest rates and make the currency even more attractive for speculators. A commitment to a certain exchange rate de facto means the end of independent monetary policies.
26. **Because of unlimited dollar purchases China’s foreign reserves reached \$2.273tr in September, or \$366bn more than just one year ago** (the latter happens to be about equal to the balance on current account surplus over the past four quarters). While the transmission mechanism that links base money with, say, M3 and bank credit has broken down in the US and the euro area, much to the dismay of central bankers there, it seems to be working quite well in China. M2 – which consists of money in circulation, demand deposits and “quasi money” - has been up by no less than 29.4% y/y last month. Bank lending is no doubt expanding at a similar rate.
27. Since China’s nominal GDP has increased by “only” 6.4% y/y in Q3, **money supply growth has far exceeded the amount needed to accommodate the growth of transactions.** (Incidentally, real GDP was up 8.9% y/y in Q3 which translates into a GDP deflator of -2.3% y/y: we have here a 19th century-like combination of strong economic growth and deflation!)
28. **So the money not needed for supporting the real side of the economy has ended up in asset markets. These are booming.** Since the beginning of the year, Shanghai has gained 83%. As to the other dollar-pegging countries, stock markets were also doing extremely well: Taiwan 67%, Hong Kong 58%, Malaysia 45%, Thailand 53%, Mexico 39%, Egypt 35% and Saudi Arabia 31%.
29. To put things into perspective: in spite of the liquidity-driven boom, **stocks listed in Shanghai** are still 43% below the level reached in October 2007, more than two years ago, while today’s average price-to-earnings ratio is also much lower (35 versus 52, on four-quarter trailing earnings). Even so, a p/e ratio of 35 is very elevated from a historical perspective: back in 2005, not a bad year either, the ratio was around 18. The message is: **yes, there are signs of a new stock market bubble but this does not mean another crash is imminent.** Stock markets which are under the spell of “irrational exuberance” have a way to outlast – and ruin – investors who try to short them.
30. I cannot find the source of a comment I read about **Chinese real estate prices** – they seem to have taken off as well (Perhaps someone who happens to know where to find them can drop me a line). It would be plausible, though, that private homes and offices are also seriously overpriced by now.
31. Hyman Minsky, the leading analyst of financial crises since Irving Fisher, has argued that a **long period without crises tends to increase the willingness to assume risk, to buy assets at ever higher prices.** While this makes the system more and more fragile, market participants tend to ignore warning signs such as rising debt levels, long-lasting asset price appreciations and a swelling chorus of broker reports which assure us that “this time is different”(as Carmen Reinhard and Kenneth Rogoff have called their new book on the history of bubbles). Sooner or later fragile systems will crash.

32. **In many of the emerging economies other than China the environment has been very benign as well and thus prone to the development of bubbles:** appreciating or stable currencies, rising foreign currency reserves, fairly robust growth during the global recession which has led to claims that they have achieved a “decoupling” from the rest of the world, low inflation, low real interest rates and moderate government deficits. International dollar liquidity (defined as the sum of currency in circulation plus US Treasury holdings of foreign institutions at the Fed) continues to expand at annual rates of about 15%, much faster than global nominal GDP. **In short, it is by now likely that asset prices in major emerging markets have lost touch with reality, ie with fundamentals such as realistic earnings prospects and the prices of alternative asset classes.**
33. **As an aside, let me say a few words about the Chinese exchange rate.** American and European politicians are urging the authorities to let the yuan appreciate by stopping interventions. The accumulation of reserves has reached about 50% of GDP and thus exceeds any precautionary needs by a wide margin. Interest earned on dollar assets (Treasury bills, notes and bonds, US Agencies) as well as euro and yen assets is far less than on domestic assets. If an economy grows by 9% in real terms, it is a safe conjecture that real returns on investment are of this order of magnitude as well. Capital exports do not make much sense from this perspective – they are a waste of resources. A poor country should not do this.
34. Incidentally: **what would be the “right” exchange rate of the yuan?** One can argue that medium-term equilibrium is where it equalizes GDP at purchasing power parity and market exchange rates. Since China’s share in global PPP GDP is 11.4% while the share in terms of actual FX rates is just 8.05%, a rate of 4.82 yuan per dollar would be appropriate. Note that the IMF used to give China a much larger PPP weight than today which means the necessary appreciation of the yuan might be even larger – if the earlier PPP estimates had been more to the point.
35. On the other hand, **it is good for growth when the economy is internationally competitive** (dollar prices are low) and the exchange rate does not fluctuate much. Once the catching-up is achieved, China may let go, but this is still a long haul. Per capita GDP is only about one fifteenth the level of the euro area. Japan and Germany have shown how high growth can be achieved by the combination of high saving and investment rates, fixed exchange rates and capital controls. Stable exchange rates promote investment spending because they stabilize price expectations and thus reduce frictional costs associated with fluctuating price signals. In any case, a surplus country which restricts capital flows, such as China, cannot easily be forced to give up the dollar peg. Its finances are sound.
36. The Chinese government can also argue that imports have been falling much less than exports lately and that real retail sales are rising considerably faster than real GDP. **Growth is presently driven by domestic demand, just as the doctor has prescribed.** China stabilizes world growth. Not to forget, if its exports are indeed so cheap, it means that the buyers realize welfare gains – they can consume more than they produce. If it were not for America’s and Europe’s unemployed everybody would love to buy cheap Chinese goods again!
37. **China is certainly a main driver of commodity markets, together with those speculators who are fleeing into liquid real assets** because they fear that all this pump-priming will inevitably lead to a destruction of financial assets by way of (hyper-) inflation.

Commodity-producing countries such as Russia, Australia, Canada, Norway or South Africa must regard China's growth strategy as a godsend.

38. **The question is whether commodity prices can keep rising:** **a)** Raw materials do not earn interest and thus benefit from low interest rates. It does not make a difference if I get zero percent on gold or zero percent on a 3-month US T-bill. **b)** For China, inventories of certain commodities are a conservative alternative store of its wealth. **c)** Moreover, prices of gold or oil can rise further – the sky is the limit - while the T-bills can not, once their interest rate hits zero percent. **d)** For the time being, commodity prices are also boosted by the upbeat consensus on world economic growth, especially commodity-intensive industrial production, and the associated expectation that inflation will rise. **e)** Finally, investors who are looking for a safe haven and do not believe in the long-term stability of the dollar (or alternative paper currencies) are almost forced to invest in commodities. There is, as we have seen, no lack of liquidity. **f)** It may also play a role that the appeal of tax havens such as Switzerland is fading quickly.
39. **In spite of all these arguments, I have no doubt that commodity prices, at multiples of their pre-2004 levels, are too high and will come down.** I have to see stronger evidence that inflation is getting out of control. As we have seen in Japan, as long as banks do not start lending aggressively again, an explosion of base money and government deficits, or zero interest rates, does not translate into rising inflation as long as banks, non-financial firms and households are mainly concerned about reducing leverage. Even in fast-growing China the prices of goods and services are not rising these days – in Q3 the GDP deflator was -3.9% y/y!
40. Finally **a few comments about Russia. The recession has been extraordinarily deep.** It has mainly been caused by the crash of commodity prices between the spring and the end of 2008. This, plus the huge depreciation of the rouble had led to an almost catastrophic decline of the terms of trade, ie general living standards. As it turned out, the banking sector was also in trouble: the previously strong rouble (on the back of the commodity boom) and low interest rates abroad had tempted banks to seek foreign funding. The corporate sector could not resist this temptation either. This caused a debt and liquidity crisis as well as one of the world's most severe stock market crashes. Real GDP will be down about 8.0% y/y in 2009.
41. **In the meantime, the situation has vastly improved, thanks to the recovery of commodity markets:** the trade surplus, the rouble exchange rate and government revenues are rising briskly again while the inflation rate has fallen to single digits. The central bank intervenes to stop the rouble from appreciating too much, besides steadily lowering interest rates. Spreads of foreign-currency denominated government bonds over benchmarks are back to "normal" levels (about 200 basis points for the 5-year duration) and seem to continue on their downward trend. Inflows of foreign capital have visibly accelerated, even though the political situation has not improved. Corruption remains endemic. Investors seem to accept these risks because they see Russia's growth potential as a reasonable compensation. The country is still too dependent on commodity exports but the diversification of production into other goods and services is picking up speed again. Foreign direct investments play an important role in this process.