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# Investment Outlook

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1. **The recovery of the world economy continues, more or less according to plan. However, there is a nagging feeling among investors that this is not really a normal and predictable upturn:** they are afraid of inflation and deflation at the same time, of the effects of money printing, of ballooning government debt and, suddenly, also of sovereign defaults. Tax havens are no longer what they used to be and could actually be threatened with extinction.

2. Moreover, **another leg down in global output is a distinct possibility**: the deleveraging of American and Spanish households, among others, has not yet run its course, banks are still repairing their balance sheets, the US commercial property market may turn out to be the next hard-to-control calamity, and no one knows what tighter fiscal and monetary policies, as they are discussed now, will do to overall demand. Many are doubtful that the recovery is already sustainable without policy support.

3. The recent past has been a pleasant surprise, though, and the **near-term future looks bright** as well. Following expansionary fiscal policies, government rescue operations for troubled banks and insurance firms, massive injections of central bank money and policy rates at or near zero, growth has now not only taken off, it has gained momentum.

4. Commodity markets are almost booming again and have made up much of the territory lost in the crash of the second half of 2008, driven by a strong pick-up of commodity and energy-intensive industrial production. Except for Japan, **consumer price inflation accelerates everywhere**, in spite of a considerable amount of slack and subdued labor markets. Deflation is not a headline topic anymore.

5. **Inventories have been the main contributors to global growth** – because the recession had been so deep, and sentiment so depressed, they were cut to the bone in the winter of 2008/2009 and had to be replenished rapidly when final demand began to stabilize. This is a typical feature of any recovery from recession. Inventories are not yet back where they should be and will thus **support GDP growth in the first and second quarter which virtually guarantees that growth rates will surprise positively**, apart from the fact that this winter has been particularly severe in the northern hemisphere, implying an unusually large need to accelerate production as soon as the weather improves.

6. **Another positive surprise in the near-term will be corporate profits**. As in any recession, they had been hit much more than labor income but are now rising at high rates as the economic recovery takes hold, especially in financials and technology. In the first round, companies had focused on cost cutting, especially by laying off staff - Germany being the major exception -, but by now it is revenues, the so-called top line, that are adding strength to earnings. Brokers are beginning to publish up-beat reports again.

7. **Global real GDP is currently expanding at an annualized rate of about 3½ %, the weighted average of 2½ % for mature industrial countries and 6% for emerging markets.** As an aside: the latter will continue to grow at least two times faster for years to come, simply because their capital stock is still very small while investment ratios are high (China 41%, India 35%, compared to Germany's 19% and America's 16%). In purchasing power parity (PPP) terms – which give poorer countries a significantly larger weight – the world economy is moving ahead at a rate of somewhat more than 4%. This looks impressive but is actually quite disappointing.

8. In view of the extremely low rate of capacity utilization, much higher growth rates would not surprise. The IMF has calculated that in the five years to 2007, global (PPP) output has grown by an annual average of 4.66%. Assuming this is, or could be, the new growth trend means that GDP growth rates of 3.0% in 2008 and -1.1% in 2009 have caused a gap of about 7½ % between actual and potential global output – a record. Unemployment rates are correspondingly high. **The output gap will not go away unless growth exceeds 4.66% by a considerable margin. Seen from a different angle, neither firms nor workers have any pricing power.**

9. It is therefore **puzzling that consumer, producer and import prices, and commodity prices in particular, have recently been rising so quickly.** From the last lows at the turn of the year 2008/2009, oil is up 122 %, copper 154 %, nickel 124 %, aluminum 83 %, steel 72 % and gold 57 %. In dollar terms, the all-items Economist commodity-price index is 26.4% higher than one year ago. Copper and gold are near their all-time highs again and thus well above their long-term trend lines – the others, with the exception of steel (overcapacities?), are made up about half the distance between the last lows and the bubbly valuations of spring and summer 2008.

10. As I see it, the main reason for these high inflation rates in commodities is the fact that industrial production rather than services is the driving force of the global recovery. There are some energy-intensive services such as tourism and logistics, but in general it takes more raw materials and energy inputs to manufacture goods than to provide services. **The new economic boom in emerging economies – actually the global growth engine - is a basically boom of industrial production.** Poor people want to buy things rather than pay for massages or trips to the beach.

11. Some more numbers? Year-over-year, China's industrial production has increased 18.5%, Brazil's 18.9%, India's 11.7%. Not only that, the laggards are catching up quickly as well: Russia's industrial output has moved ahead at a 6-month annualized rate of about 22%, America's of 8.9%, Japan's of 22.9%, and even Germany tries to join the party (+9.4% Q4/Q2 saar). To a large extent, all this **reflects the turn-around of the inventory cycle, but also that Keynesian-style stimulus programs can be successful when there is a lot of underutilized capacity.**

12. **In light of these growth rates, high commodity prices look plausible - even higher ones would.** Since households' spending habits and firms' production structures do not adjust quickly to a new pattern of relative prices and costs (ie to more expensive raw materials and energy), the immediate impact is to drive up overall price and cost levels. This is what we observe right now. Medium-term, adjustments can be expected, though, such as a reduction of demand for these items, often in the form of substitution (for instance gas for oil) or an improvement of efficiency. Moreover, high commodity prices usually boost supply - which in turn brings them down again.

13. In other words, **we experience a change in relative prices, and are not necessarily in the early stages of a new era of high inflation**. Really? Headline consumer price inflation is now 2.6% y/y in the US, 1.5% in China, 0.9% in the euro area, 3.5% in the UK (but -1.7% in Japan). Only a few months ago, inflation rates, with the exception of Britain's, were all well in negative territory. Investors could be forgiven if they see this as a prelude of worse things to come.

14. Moreover, didn't all major central banks until recently aggressively print money in order to stimulate their economies and to avert deflation? Inflation is, as we have learned, a monetary phenomenon – if the supply of base money rises faster than output (real GDP) the price level must automatically rise as well. So, looking at the explosion of central bank balance sheets in the US, but also in the euro area, the UK and China, one can easily be concerned. Indeed, **many investors think hyperinflation has a fairly high probability.**

15. Recent experience as well as the history of the US Depression and Japan's long fight with deflation show that there is, in certain circumstances, no such automatism: **strong growth of liquidity and zero interest rates are compatible with very low inflation and even deflation.** The money multiplier is not comparable to a car's cardan shaft which transmits power from the engine to the wheels in a controllable fashion. Note that monetary aggregates (in the US or the euro area), such as M3 or total loans outstanding, are five to seven times larger than the central bank's monetary base.

16. **The catchword is deleveraging, the accelerated reduction of debt accumulated during a preceding asset price boom.** The market value of assets such as residential property, equities or asset backed securities has come down so much that they are worth less than the money owed. Providing ample and cheap liquidity to borrowers does not hurt but it does not, in itself, drag borrowers out of their debt trap. The problem is not liquidity but solvency. They have to cut costs, invest less, ask shareholders for fresh funds, lower dividend pay-outs and do everything to boost profits and the equity base and thus improve balance sheet ratios. The decline in year-over-year lending by banks in the US and the euro area (and the shrinking American commercial paper market) probably reflect the on-going deleveraging processes there. Inflation rates in these economies will inevitably come down again as long as this continues.

17. **Loan shrinkage is, of course, also a by-product of the still depressed rate of capacity utilization**: capital expenditures are low, consumers save more because they are afraid to lose their jobs, and banks avoid risky business, not least because they anticipate the effects of regulatory reforms. Their future equity buffers will have to grow: in order to achieve target returns on equity (ROEs) banks will therefore lend less and at higher margins. While rated companies can turn to capital markets, and issue bonds and money market paper, small and

mid-sized firms do not have that alternative. There is a strong pro-cyclical element in all of this. But it is, of course, good news for all those who would lose when inflation got out of control.

18. **Deleveraging has come a long way by now, especially in banking, thanks to ample and cheap (short-term) liquidity and steeply sloped yield curves.** In the euro area, for instance, overnight interbank money costs just 0.33% (EONIA) while German 5-year government notes yield 2.3%; 5-year Pfandbriefe (covered bank bonds) earn 2.67% today. Borrowing short and investing at longer maturities is a fairly safe and very profitable strategy - as long as the ECB does not reverse course. At more than 7%, interest rates on consumer credit are even more attractive for banks. Their earnings have also benefited from the fact that the number of competitors has significantly shrunk since the outbreak of the financial crisis in the summer of 2007. Overall, the solvency of large European banks has significantly improved, despite record write-downs and charge-offs. The same holds for American banks.

19. **It is too early, though, to sound the all-clear. In the US, in the UK, but also in some emerging economies there is the risk that deleveraging may go into a second round. This time the trigger would not be residential real estate and so-called toxic assets derived from it but commercial real estate**, ie office buildings, shopping centers, industrial parks, housing developments and hotels. Their prices have fallen by more than 40% since the beginning of 2007, and about half of the loan volume of $1.4 tr that falls due between now and 2014 is financially under water: borrowers owe more than the underlying property is currently worth.

20. In the US, the Congressional Oversight Panel has just published a report which states that " … **a wave of commercial real estate loan failures could threaten America's already-weakened financial system.** [The panel] is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation's mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy." (p. 2) The sequence of events continues to remind me of what has happened in Japan. If monetary and fiscal policies are now tightened as a next step, the resemblance would be near-perfect. It could be deflation after all.

21. A word about the **role of energy and raw material prices in the inflation proces**s: in advanced economies it is much smaller than popular perception has it. A representative national production function has the following structure: labor 65%, capital inputs 20%, imports 15%. In the case of Germany or the US, less than 10% of all costs consist of imported commodities. So even a 30% price increase boosts overall costs by at most three percentage points – and then it is not a foregone conclusion that these higher costs can be passed on to customers.

22. **Inflation mentality is certainly not on the rise again.** One indicator is provided by inflation-linked government bonds – according to these, the 10-year break-even inflation rate is 2.3% in the US and 1.9% in Germany. Both these numbers are thus not only unchanged for quite some time, they are also close to the two central banks' targets and thus rather reassuring. Investors still trust their money-printing central banks. Surveys among professional forecasters show similar results.

23. **What are investors to make of the Greek crisis?** The Financial Times had some op-ed pieces today and recently which conveyed the message that the euro project has now entered its end-game. "I had told you it could not work!" Countries like Greece, or Ireland, Portugal and Spain, even Italy and Belgium find themselves in straight-jackets that leave them without policy options – they can neither adjust nominal interest rates, nor the volume of central bank money, nor the exchange rate. They have some fiscal policy options, but only in the sense that they can tighten some more – expansionary strategies are taboo once the Maastricht deficit and debt limits are significantly breached.

24. **The euro area is simply not an optimal currency area**: Germany, the Scandinavian countries, the Netherlands, Austria and Switzerland could be one, the countries bordering the Mediterranean could be another. Fiscal conservatism, current account surpluses, high per-capita incomes and a belief in open borders and competition characterize the memebers of the first group, while the countries of the Club Med are almost the exact opposite. The two parts of the continent are too different for the euro to survive in its present form. Also: forget about political union. I beg to disagree.

25. But this is presently the theme played by markets. **The weakness of the euro could well continue, especially if the Greek government's proposed reform package is dismissed by the hardliners, ie the potential creditors.** Since the country's large debt-rollovers are still several weeks away, there is no strong pressure at the moment to come up with a concrete rescue plan. Default, voluntary exit from the currency union, dismissal and the conditions which Greece will finally have to accept will dominate the discussion some more time, creating the impression of indecisiveness. In the end, there will be a solution, though - because there must be a solution. The risk of contagion and a collapse of the European (and the world's) banking sector is simply too large. Lehman was bad enough – this would be much worse.

26. **The Council of Ministers has actually made clear that there will be a rescue, but it will come at the last minute, after an all-night negotiation**. This is the way Europe has moved forward in the past. In the meantime, there will be ambiguity about the likely outcome. Greece cannot be permitted to relax as yet. The main progress, in the eyes of those who think European political union is a good thing for a continent with shared values but almost 60 different countries, is that the Greek and other spendthrift governments will be more closely supervised – which means countries will give up further autonomy and strengthen Brussels. The British will hate it and do their best to prevent it. As Tommaso Padoa-Schioppa has written today, one lesson of the Greek crisis is that the other countries failed "to exert peer pressure and [refused] to grant the Commission sufficient power and independence, including the power to establish the right statistics." (FT, p.9)

27. **Greek government bonds will probably remain under pressure, just as the euro exchange rate and the bond markets of the so-called peripheral countries**. A weak euro is a good thing as long as there is so much slack in the euro area economy and no risk of inflation. No one will say this is really a beggar-thy-neighbor policy (as in the case of China). I am willing to bet that the euro will bounce back by at least ten US-cents once the contours of the rescue package for Greece become apparent. And 10-year Greek government yields will drop to less than 4½ % in no time (which translates into a capital gain of about 12%).

28. **In general, investment grade government bonds are good bets at this point**. The inflation scare is overdone. The implication is also that gold - I repeat myself - is not useful as an inflation hedge and should be sold, especially if investors are overweight in the metal. Why not buy some inflation linkers instead? A reliable, if uneven, cash flow is a good thing to have when income prospects are uncertain.

29. **Corporate bonds have become more attractive – ie cheaper - in recent days** as the risk of sovereign defaults has become palpable. Since I do not think that this is actually a serious risk, I should recommend corporates. But I am also afraid that the financial crisis may enter a second round later this year, meaning a return of the global recession, or much slower growth. Risk premia would then rise further. In short, it probably pays to wait.

30. **Equities are well supported in the near-term** because the flow of economic statistics and news on corporate earnings will surprise on the upside for a while. The same holds for commodities. I would not buy stock indices. Markets as a whole are not really cheap on the basis of trailing profits, while current and next year consensus earnings estimates are probably too optimistic.

31. **No, this is a time for stock picking**, and especially for defensive stocks with healthy cash flows which can be expected to withstand a new crisis. Utilities and telecoms come to mind. Another investment theme is exporters to those large and dynamic emerging economies which have successfully decoupled themselves from American and European importers. There are now some countries of this kind (they usually have large currency reserves and high investment ratios). In that context, investors could also place bets on stocks of firms which cater to domestic demand in these economies, including service providers in financials, logistics, retail or tourism.

32. **The euro is out of favor, and will remain so for while as the Greek drama drags on**. But interest rates are relatively high, overall budget deficits are half as big as America's, the current account deficit is in the order of 1% of GDP, and the large devaluation of recent months calls for a concerted attack on all those shorts. Once the political fog clears, the euro will have a nice renaissance.

33. **The yen** will benefit from the improvement of Japan's balance on current account: neighboring China is in a full-scale investment boom. One effect is that Chinese imports are almost 100% higher than twelve months ago. Japan is the obvious beneficiary of this.

34. **The Swiss Franc** has been appreciating against the euro and depreciating against the dollar as the Swiss central bank tries to limit the franc's strength vis-à-vis the currency of Switzerland's largest trading partner. This will continue, but it is only a matter of time before parity to the dollar is reached again. No other country has such sound fundamentals.

35. **To conclude, near-term** the dominating factors are fairly strong growth globally, rising inflation, rising profits, well-supported stock and commodity markets, a weak euro, probably rising bond yields. Both **the ECB and the Fed** will talk about tightening the reins, but are actually unable to do so. The former has to tread carefully as the Greek crisis could easily spin out of control following a wrong move, the latter must be scared by the looming crisis of commercial property markets and the risk this entails for financial stability.

36. **Longer-term, growth will slow,** especially in the US and other highly leveraged countries - inflation rates should then come down, bonds would once again outperform stocks, and euro, Swiss Franc and yen will appreciate. The renminbi may take its next leap forward later this year as export competitiveness is no longer of overriding concern for the Chinese government – FX reserves are probably too large already, inflation is on the rise, and domestic demand needs some cooling by means of higher interest rates.

## Appendix: Russia’s longer-term prospects

37. **Investing in Russia is fairly risky, both in terms of market volatility and business environment, but expected returns are correspondingly high.**

38. In 1998 the stock market fell 83%, and by another 80% from mid-2008 to early 2009 – in both cases crashes were followed by vigorous recoveries. Other key variables such as oil prices, the rouble exchange rate and property prices are also extremely volatile.

39. As far as the ease of doing business is concerned, corruption is endemic, the rule of law is not generally accepted, including property rights, the political system is centralized and autocratic, the income distribution very uneven, it is difficult to set up business, and so forth. Since Gorbachev’s perestroika campaign of the eighties, modernization and improving the investment climate have always been at the top of the political agenda. As it is, things got actually worse during the last decade. **The relatively unfriendly investment climate is partly responsible for the somewhat disappointing growth performance of a country so richly endowed with natural resources.**

40. GDP per capita has been €6,685 over the four quarters to 3Q 2009 (at an exchange rate of R41.34 per euro) and is thus just 22.7% of Germany’s. **Russia is still a poor country, even though the gap is smaller when purchasing power parities rather than market exchange rates are used.** The positive aspect of this is that the catching-up potential is considerable. With a population of 142 million, the country is Europe’s largest.

41. **Average real GDP growth has been 5.0% over the nine years to 2009**; the corresponding numbers for China, India, Brazil and Germany have been 10.0%, 7.2%, 3.1% and 0.5%. That growth is slower than in the two Asian countries is partly due to the fact that these are poorer and thus even further behind economically: China’s GDP per capita is only €2.499, India’s a paltry €703.

42. Assuming real GDP growth rates of 5% for Russia and 1% for Germany, it would take 38 years for Russia to catch up, assuming a stable exchange rate and the same average inflation rate (GDP deflator). If the growth rate could be raised to 8%, it would still be 22 years. In any case, **these numbers show the long-term potential of the country, provided, of course, that the right micro and macro policies are pursued and such high growth rates can indeed be achieved.**

43. Another reason **for Russia's sub-par growth rate is the relatively low investment ratio of 21.2%** which is comparable to Germany's but not to China's or India's - which are almost twice as high. The capital stock and therefore productivity simply do not grow fast enough.

44. **For much of the last decade, the overvalued rouble had been the main culprit for the disappointing level of capital expenditures**. On the back of the commodity price boom the demand for the Russian currency had been very strong – for six years until the fall of 2008 the exchange rate was fairly stable at about 35 roubles to the euro even though consumer price inflation averaged 11 ½% which was about nine percentage points higher than in the euro area (under normal circumstances the rouble would have been a depreciating, not a stable currency!).

45. In other words, the so-called **real exchange rate vis-à-vis Russia's largest trading partner rose by almost 70%** during this period – it triggered an import boom and wiped out large segments of industry, especially those that were not involved in commodities or were not shielded from international competition in one way or another. This is called the Dutch disease, or the commodity curse.

46. The dependency on producing and exporting raw materials became brutally clear when commodity prices crashed in the second half of 2008: **Russia's real GDP shrank by no less than 8% y/y in the following year** while China and India merrily continued to catch up with the advanced economies and became the world's growth engines in the process.

47. **Banks and consumers were hit particularly hard**, the former by a big increase in non-performing loans plus unexpected problems with servicing their foreign debt (which had looked temptingly cheap when the rouble was stable while inflation and domestic interest rates were high), the latter because real household incomes had crashed when unemployment shot up and wage inflation came to a halt.

48. **Going forward, there are no serious imbalances any more.** The rouble has found a level, it seems, where it fluctuates within a fairly narrow range. The central bank has more or less stopped to intervene. This reflects the new stability of commodity prices: they are at a comfortably high level after last year's recovery but will not get near the bubbly regions of spring and summer 2008 – global output gaps remain large and will thus prevent new excesses. To be sure, though, compared to pre-2004 standards, commodity prices are extremely attractive for exporters. Russia is obviously a main beneficiary.

49. **The balance of trade** had been on the brink of moving into the red earlier last year (which is not necessarily bad for an emerging economy); for more than two quarters surpluses have now been rising again, not least because imports are rather subdued: the previous depreciation of the rouble, persistent labor market problems and a negative wealth effect (equity and property prices are well below the levels of 2008) are responsible for that. The **current account surplus is presently almost 4% of GDP** – it is one of the world's largest. Russia is a major net exporter of capital and thus one of the most solvent countries. I would not be surprised if long-term foreign currency credit ratings would soon be revised up from Baa1 stable (Moody's) and BBB negative (S&P).

50. **Fiscal policies have turned conservative**. Last year's budget deficit was probably no less than 7.2% of GDP; it came on the heels of a surplus of 4.8% in 2008 – a swing of no less than twelve percentage points. The government argues that the potential for fiscal stimulus is

now exhausted, even though much richer countries such as the US and Britain are running much larger deficits. The risk is that stabilizing budget expenditures at the 2009 level could be a massive shock to the economy. Since inflation is in the order of 8%, real spending would fall at this rate and thus drive up unemployment.

51. It must not be so bad. Since the rouble continues to appreciate against the dollar-euro basket Russia is importing price stability via falling import prices. In addition, wage inflation is very moderate and close to zero in real terms. This means that **consumer price inflation will probably recede further and reach 5% by year-end 2010, mostly because the output gap is still huge.** The reduction of real government spending will certainly be much less than those 8%.

52. **One supporting factor for economic growth is easier monetary policies**. The central bank can afford to cut interest rates as the rouble pushes against its informal upper limit. The emergency borrowing rate at the central bank has been cut to 8.5% today (comparable to Germany's old Lombard rate), a record low. There is no intention, it seems, to intervene as massively as in the years of rapidly rising commodity prices (since 2004), but the rouble should not appreciate too much either. A new import boom, caused by an overly strong currency, is a scary prospect for the administration. The labor market needs a competitive exchange rate. This is a sensible strategy.

53. **Real GDP will increase by about 5% year-over-year in 2010**, followed by similar or higher growth rates in later years, depending on the reform process, in particular the success in stimulating capital spending.

54. **Listed equities should do well**. According to consensus earnings forecasts for 2009, the average price-to-earnings ratio is just 8. A stock market that is dominated by commodities and energy, ie unsophisticated mass products, and a lack of well-recognized brands, is bound to be relatively cheap, but even so valuations are not over the top. For some years, the best bets will be lesser-known stocks, or those which benefit from regulatory reforms and the interest of strategic buyers.

55. **Non-listed companies are even more attractive.** P/E ratios are frequently in the order of 4 or less. The investment climate is gradually improving but is not yet outright favorable, so it takes a solid familiarity with market practices and a reliable network of contacts to succeed in such an environment. Russia is one of the last frontiers, with an unusually good potential to succeed financially. The **rising middle class** has a strong interest to secure their property rights and the rule of law in general, while the government is under pressure to get serious about improving the investment climate. Progress on this front is almost inevitable because the government has a credibility problem if the discrepancy between fine words (about perestroika) and actions continues to persist.