

Economic Review

By Andrew Hunt

Q3/06

Global inflation

One of the surprises of 2006 has been just how fast the perceived threat from inflation has dissipated not only in the USA, but elsewhere as well. While there might be a tendency to attribute the apparently rapid dilution of the inflation threat to the US Federal Reserve's shift towards a tighter interest rate regime, and the perceived resulting slowdown in the US economy, we believe that the answer to the question of why inflation has not materialized lies elsewhere. We suspect that a combination of rising commodity input prices and excess capacity in China has led to a severe profit squeeze within the Asian region and this profit contraction has led to extremely weak investment and employment cycles in many Asian countries. These weaker corporate trends have then been reflected in extremely weak domestic demand in the Pacific Rim and hence the profit squeeze has created even more severe excess capacity problems. We suspect that it has been the increase in the latter which have led to the reduction in global inflationary pressures.

Certainly, it is noticeable that the recent better inflation data within the Western economies has not only been the result of slightly lower energy prices, but also significantly lower prices for consumer durables such as computers and household goods. Many of these goods are, of course, produced in Asia and hence the emergence of high levels of excess capacity and intense competition in the Region has exerted a significant and beneficial impact on Western inflation rates. This could be described as a situation under which Asia has sacrificed its profitability through the creation of excess capacity but, in so doing, it has provided the West with an inflation 'subsidy'. Certainly, the recent better inflation in the West has little to do with domestic OECD trends, which in general remain predominantly inflationary.

This positive inflation surprise has of course been beneficial for global financial markets but this impact has been amplified by large capital market-related flows from Asia. The decline in Asian profits has resulted in an intense search by Asian investors for better returns outside the Region and, in fact, we are now witnessing record levels of capital outflows from Asia. These flows are apparently finding their way to the West, where they have exerted a directly positive impact of both bond and equity markets.

In fact, we suspect that these capital flows may succeed in revitalizing the Western economies. Under the strong influence of renewed Asian capital inflows, US bond yields have tumbled over recent months and mortgage rates have followed them downward. Perhaps surprisingly, this drop in effective borrowing costs has already attracted the attention of the US household sector, which has recently begun a re-acceleration in its rate of mortgage borrowing growth. Thus, by not investing domestically and saving more, Asian companies may now be providing yet more fuel (in the form of the Region's 'excess savings') to the US economy's growth.

Consequently, we would not be surprised to witness faster US growth in the near term, particularly now that gasoline prices have also subsided. For financial markets over the next six months, we wonder whether the 'surprise' may be that Asian economies are weaker, and the US economy stronger, than the markets are currently expecting – events that are likely to be supportive of the USD. Moreover, such an outlook would appear likely to be

neutral for bond markets, since this outcome is unlikely to threaten the current glut of Asian goods supply, while being positive for equity markets.

Longer term, this situation is clearly not sustainable. Ultimately, Asian companies will be obliged to charge prices to their Western customers that reflect their now elevated costs bases but, in a situation that is directly analogous to Japan over the last decade, this change in pricing behavior is likely to be gradual. Hence, while we believe that rising Asian inflation will one day threaten the global expansion, this point does not yet appear to have been reached.

Although the primary cause of Asia's profit weakness lies with the behavior of commodity prices and China's overbuilding of capacity, some of the weakness may also be due in part to the Bank of Japan's recent over tightening of its monetary regime. We firmly believe that the Bank's ending of both the Quantitative Easing Policy and the Zero Interest Rate Policy was conducted too early and that this premature tightening has led to weaker retail demand – and that this weaker consumer spending will have implications for the whole economy. Thus, we expect Japan's economy – and its equity market- to under perform consensus expectations for both economic growth and financial market returns.

In Europe, the prognosis appears somewhat brighter. Although Italy's economy is clearly suffering the trade competitiveness problems that one would associate with its previous failure to adhere to the domestic cost inflation strictures of its Euro participation, domestic demand trends have picked up in Germany and remained firm in both France and Spain. They also remain very strong in Scandinavia. Moreover, although the European Central Bank is expected to continue to raise interest rates over the next year in an effort to cool the Iberian / Nordic / Eastern Europe credit booms, we doubt that the level of interest rates will become sufficiently prohibitive in the near term to control the booms in the stronger parts of the Euro Area.

In particular, it is doubtful that, with Chinese / Asian export prices continuing to fall, the ECB will receive a 'mandate' from the inflation numbers (i.e. they may not be high enough) to properly cool the boom. Thus, we expect that growth in the EU, and its satellites, may remain firm, although Italy's problems could yet constrain sentiment towards the EURO exchange rate.

In the UK and Australia, it is clear that the long credit booms that have supported these countries' growth rates over recent years are not only continuing, but also accelerating. Given that these economies are perhaps even closer to their capacity constraints than the US economy, we expect both higher inflation and higher interest rates in the UK, Australia and New Zealand before year end.

However, our general forecast for the global economy remains relatively benign. Although the global credit boom has become quite extended, Asia's continuingly beneficial and largely deflationary impact on World Trade Prices should continue to ensure that global CPI inflation remains tame in the near term (despite the negative effect that this is having on Asian profitability). This event, coupled with the now significant investment capital outflows from Asia, should underpin western markets (particularly equities) in the near term. Hence, we are optimistic for both financial markets and the USD in the near term.

In the longer term, Asian will of course be obliged to raise its export prices in order to rebuild its own profitability. Such an event will in turn threaten OECD inflation and interest rates (the latter could become obliged to rise quite sharply in this situation) but, as yet, we see little sign to suggest that this longer term constraint on global growth is materializing and we therefore remain positively optimistic over the outlook for financial assets in the near term. ■

About Andrew Hunt

Sparinvest works with Andrew Hunt, independent economist of Hunt Economics. In his market comments he gives a precise and unreserved analysis of the economic development. As we at Sparinvest do not claim to be able to predict the economic trends, we pass on the market comments to illustrate the degree of uncertainty within the economic future, which at the same time emphasizes the importance of thoroughly diversified portfolios. ■

Responsibility for the contents and opinions expressed in these Market Comments rests solely with the author. Opinions expressed in this document do not necessarily represent the views and opinions of Sparinvest S.A. Sparinvest S.A. assumes no liability for any content or opinion expressed in this publication, nor does it warrant that the contents are free of errors. As such no liability whatever can be accepted for actions taken based on any information that may subsequently prove to be incorrect. The opinions expressed here are the subject to change without notice.