The Absolute Return Letter September 2006

Summary

The inflation debate is raging on either side of the Atlantic at the moment. Is the current spike in consumer price inflation (CPI) temporary or longer-lasting? The U.S. Federal Reserve Bank has stated unequivocally that the current state of affairs is not likely to be long-lasting. They expect the headline rate of inflation to come back down again over the course of the next year or so.

Central banks in Europe and Asia have taken a somewhat different view; hence investors in those markets should expect interest rates to go up for a while longer – at least in the short term. However, the main thrust of this letter is a discussion of why the Fed could be terribly wrong in their analysis. This is going to be one of the most important calls you have to make over the next year or two – so much rides on the outcome.

Enjoy the read.

A High Price to Pay

"Nature has given enough to meet man's need but not enough to meet man's greed."

Mahatma Gandhi

This month we will be taking a look at what is in store as far as inflation is concerned. Or maybe we should re-phrase that. We will offer our two minutes worth on one of the most hotly debated subjects of this year. It's so hot that it was the main topic at last week's annual symposium hosted by the Kansas City Fed at Jackson Hole in Wyoming.

A prominent European economist invited to the symposium had the audacity to stand up and suggest that the Fed governors have lost the plot (well, he didn't quite say it that way but based on the press reports from the meeting, that's probably what he meant to say). The economist in question was none less than Charles Bean, chief economist at the Bank of England, and we will revert to his words of wisdom a little bit later.

The inflation discussion is important for several reasons. First and foremost, inflation has a major impact on how long-dated bonds are priced (one could argue that inflation expectations are in fact more important than actual inflation but let's not be small-minded here). Secondly, the level of inflation determines our purchasing power. The lower the rate of inflation, the less our savings are devalued every year. Thirdly, and very importantly from the government's point of view, the rate of inflation is used to regulate a large number of payments from the public sector to the private sector (such as social security benefits).

One could therefore argue that governments all over the world have a vested interest in keeping the publicised inflation number down, *because it will keep the cost to the government down*. When you work with budgets of hundreds of billions or even trillions, a decimal point or two could mean many millions saved.

For this reason it is no wonder that some people have accused their government of deliberately understating inflation numbers. There are even websites dedicated to the subject. One of the more prominent ones is called www.shadowstats.com and offers many interesting details on the subject.

However, we do not believe in some grand government sponsored conspiracy designed to keep the inflation numbers down more than we believe in Elvis Presley sitting on some south sea island drinking vodka martinis all day long. But we do suspect that the governors of the largest and most powerful central bank in the world are playing with fire. They present the inflation data in a somewhat brighter light than the numbers actually deserve. And, so far at least, markets have willingly accepted their version. Let's explain.

The Background

For about 20 years (since the early 1980s) inflation trended down all over the world. In the last couple of years, however, inflation has been creeping up again, assisted by the dramatic rise in energy and other commodity prices. A good account of the reasons behind the general fall in inflation can be found in a research paper produced by the Bank for International Settlements[1], a copy of which is available in our research library on www.arpllp.com.

The paper points to three possible reasons for the good behaviour of global inflation in recent years. The fourth one – manipulation of numbers – is not mentioned:

1. Structural changes
2. Monetary policy
3. Good fortune

The paper leans towards (and we agree) structural changes being the most important factor. After all, if lower inflation was primarily the result of a change in monetary policy, one would expect the effect to be fairly evenly spread across all sectors in the economy.

If, on the other hand, the lower inflation is mainly a function of structural changes such as deregulation or increased global competition, one would expect certain industries and sectors to benefit more than others. And that is precisely what has happened.

Also, the biggest change in monetary policy over the past decade or so has been the adoption of inflation targeting amongst central banks – with the noticeable exception of the U.S. Federal Reserve Bank which has not yet embraced this novel approach. However, there is no proof whatsoever that the U.S. Fed has been any less successful than their European or Asian peers in the conduction of monetary policy.

The Arguments For and Against

All this made perfect sense until oil prices started to play havoc with inflation rates. After 20 years of trending down, inflation is accelerating yet again. The interesting fact, however, is that it does not seem to worry more than a small minority of investors. The vast majority support the view (which has been repeatedly communicated by the Fed) that the rise in inflation is temporary and will soon be reversed again. This view is predicated on two assumptions:

1. Oil prices will collapse once the global economy slows down.
2. The deflationary force of globalisation will eventually dominate the inflationary force of high energy prices.

[1] *The Evolving Inflation Process, Working Paper No 196, February 2006, Bank for International Settlements*

Is CPI a Good Measure of Inflation?

The debate continues to rage whether the published consumer price inflation (CPI) numbers over- or understate actual inflation.

Those believing that CPI tends to overstate actual inflation are mostly academics. They reckon that CPI numbers are too high because it is a measure of price change for a fixed basket of goods and services. In reality, however, consumers substitute cheaper goods and services for those that rise in price. The product substitution effectively creates an upward bias in the CPI numbers, the argument goes.

The other camp consists mostly of ordinary people fighting to pay their bills every month. They argue that the cost of living in general is rising considerably faster than indicated by the CPI numbers.

A couple of examples from the UK illustrate this argument: According to the official UK basket of goods and services, the gas and electricity components have increased by 17% and 7% since 2003. The actual cost, however, has risen by 64% and 45% respectively.

Where do we stand? We do not care what the academics say. We suggest they get down from their high chairs and look at the cost of travelling across London every day. Or look at their utility bills. Or the school fees. Wherever we look, prices are rising faster than the rate suggested by the CPI numbers.

We do acknowledge that fast rising prices is predominantly a service sector phenomenon. Produced goods are far more likely to be subjected to the deflationary forces which have hit the world in recent years.

However, we live in a world where an ever larger portion of our earnings is spent on services rather than goods (e.g. more eating out, more travelling); perhaps the real problem with the CPI lies in the fact that our changing habits are not reflected in the composition of the index quickly enough.

In our opinion, this rather simplistic view ignores a number of issues:

Firstly, according to our friends at Morgan Stanley, Asian export prices are on the rise again after being under pressure for a number of years. Asia in general, and China in particular, has been a big exporter of deflation in recent years. If Asian export prices continue to rise, the deflation argument is seriously flawed.

Secondly, the global economy has changed dramatically since the last recession. The U.S. economy is no longer the single-engine locomotive driving global economic growth. Emerging markets, and in particular the BRIC economies (Brazil, Russia, India and China), play a far bigger role in today's world, and it is by no means certain that a U.S. recession will automatically lead to global stagnation. Analysts at Morgan Stanley have calculated that China alone has a big enough funding cushion to keep investments going for a full year, if the growth in exports falls away.

Thirdly, geopolitical risk is much higher today than at any point in the last decade. The mullahs in Iran have become savvier in the way they stir up things around the world, but they need high oil prices in order to continue their policy of global terror. According to calculations made by GaveKal Research[2], Iran takes in about $70 billion per annum in oil exports. About half of that is spent on domestic necessities (food, etc.), leaving about $35 billion to be spent on global terror. We agree with most observers that an oil price of $70 has at least $15-20 of risk premium built into it. We disagree that this premium could easily disappear. The world has seen too many terror plots in recent years for that to happen.

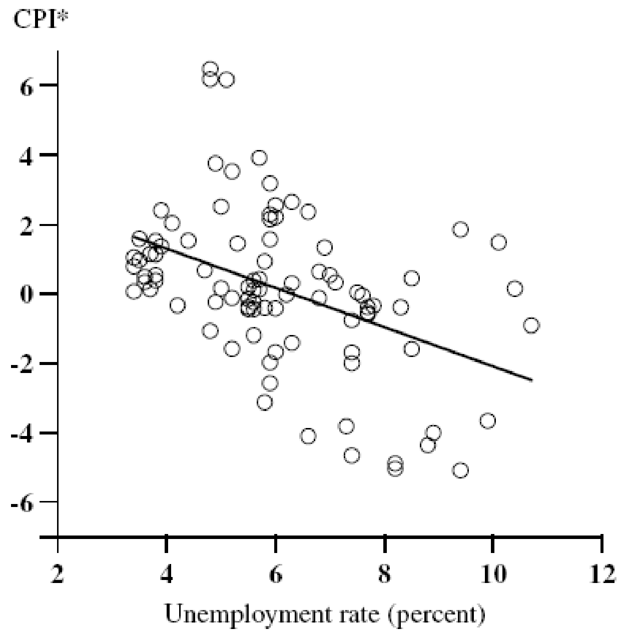
Fourthly, the oil price may *never* come back to the levels seen only a few years ago ($20 or even less). In our opinion, oil prices are driven by more than just “greedy” hedge fund managers and geopolitical risk. We would argue that the globalisation argument works both ways. Yes, the West has benefited immensely from outsourcing much of its production to Asia in recent years. But, in doing so, we have also initiated a process which will lead to much higher living standards in Asia, requiring more oil to sustain those standards. The bad news, from an inflation point of view, is that you can only outsource once, but you have to live with the implications forever.

Fifthly, monetary policy, judged by the growth in monetary aggregates (particularly in Europe), is not yet very restrictive. Commercial banks continue to lend willingly and borrowers have not yet been deterred by the higher cost of borrowing. Any signs of the higher borrowing costs taking their toll on borrowers’ appetite for risk are few and far between, at least as far as Europe is concerned. The most noticeable exception to this observation is the U.S. housing market which looks like it is in the midst of a rather dramatic slowdown.

Finally, the Phillips curve has flattened substantially in recent years (see charts 1 and 2). Please accept our apologies for getting a bit technical here but don’t give up because this is the most important part. The Phillips curve describes the interaction between the rate of inflation and the rate of unemployment.

Generally speaking, the lower the unemployment rate, the higher the rate of inflation and visa versa. In the traditional Keynesian way of thinking, policy makers can influence the future rate of inflation through changes in fiscal policy. For example, if the objective is to reduce the inflation rate, the public sector’s spending budget would be reduced (or taxes raised), putting more people out of jobs in the process. The effect, however, would be a reduction in the future rate of inflation, as long as the Phillips curve is inverted as it was for many years.

Chart 1: Short-Run Phillips Curve, 1960-83[3]

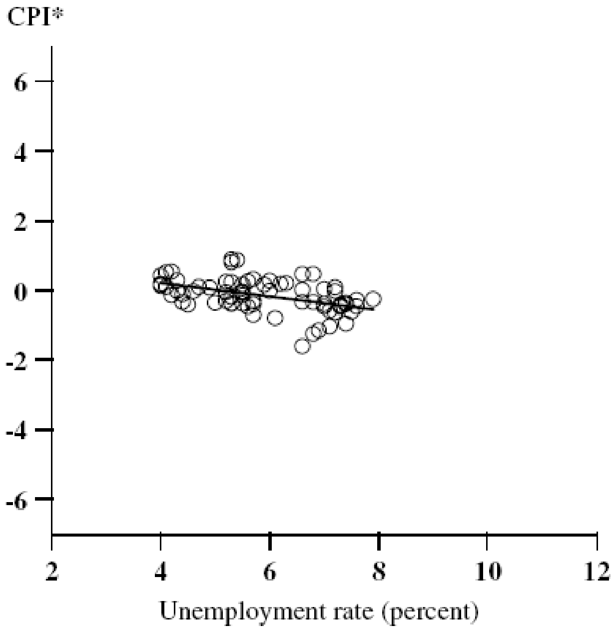


If the Phillips curve is flatter today than it used to be (as suggested in chart 2), the inescapable consequence is that inflation no longer responds to this sort of policy the way it used to. This may explain why we have been able to enjoy near full employment in recent years and no inflation to speak of. However, the reverse is also true. Once inflation is allowed to creep in (for example through higher oil prices as is currently the case), a flattish Phillips curve also means that it will be a much tougher battle to drive inflation down again.

[2] *Oil: Will the Malthusian View Carry the Day?, 24th August 2006, GaveKal Research*

[3] *Four quarter % change in core consumer price inflation over the next year. Source: Can the Phillips Curve Help Forecast Inflation, 4th October, 2002, Federal Reserve Bank of San Francisco.*

Chart 2: Short-Run Phillips Curve, 1984-02[3]



Conclusion

For all these reasons, we believe inflation could prove a lot stickier than the Fed wants you to believe. We are not alone with this view. As mentioned earlier, Charles Bean, Chief Economist at the Bank of England, told the audience at last week's annual Fed symposium that energy prices are rising for the same reason the prices of many manufactured goods are falling, namely the rise of China and other emerging market economies. He suggested that stripping out energy prices without stripping out the falling goods prices as well, made little sense since both sets of prices are driven by the same factors.

Charles Bean seems to have the backing of his paymasters. The Bank of England as well as the ECB increasingly take the view that energy prices will prove more resilient than generally perceived and that it is therefore inappropriate to exclude them from the overall number, as the U.S. Fed does.

Globalisation is indeed a double edged sword. Moving production facilities to low cost countries you can do once - perhaps twice (from, say, China to Bangladesh or Vietnam). But, eventually, you run out of options. Meanwhile, 2.5 billion Chinese and Indians are about to find out what we learned 30-40 years ago. Once you own a car, there is no going back.

As we never tire of telling our clients, almost 90% of the world's oil production goes towards transportation fuel, and demand is rising fast. As long as much of the world's oil reserves are in the hands of notoriously unreliable regimes, and as long as the commitment to lower our consumption of transportation fuel is half-hearted at best, the chances are that oil prices will continue to rise.

In Europe, our elected leaders brag about how we have managed to reduce our energy dependency through higher efficiency. The unmitigated truth, though, is that we consume more transportation fuel than ever before. The savings have been achieved through other means, not the least by turning our economies in the West from being production orientated into full blown service economies. The energy is just consumed elsewhere.

That is why we think the Fed is playing with fire. It is possible that things will turn out as they predict but the way we see it, the odds are simply not good enough to justify taking the bet. If, on the other hand, the Fed is proven wrong, one of two things may happen. Either they will come back with more rate hikes or the bond market may do the job for them by driving up the yield on longer dated bonds. Neither outcome is particularly attractive.

Niels C. Jensen

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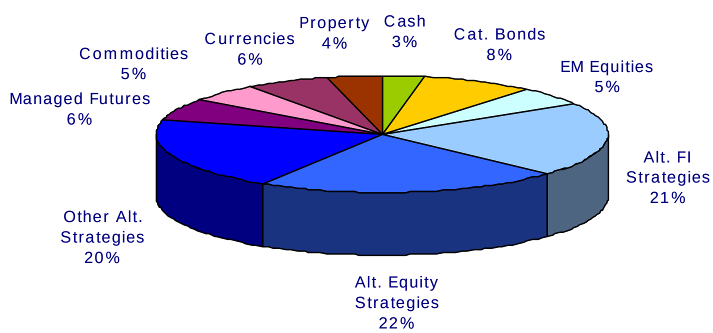
The **Multi-Strategy Portfolio** 1st September, 2006



The **Millennium Wave Portfolio** 1st September, 2006