The Absolute Return Letter
February 2007

The Price of Globalisation

"The degree to which inflation/deflation matters depends upon the nature of its sources, and upon whether it has been expected. In today's environment, accelerating inflation has not been expected, and would have adverse consequences. Thus the Fed and the markets should worry about inflation just as they currently are."

Bank of England raises Bank Rate

These lines were written by our economic advisor Woody Brock in his September 2006 report named 'Inflation – Its Origins and Likely Behavior'. Woody could not have known that some four months later, having glimpsed an inflation report just prior to publication, the Bank of England would be forced to raise UK interest rates by another 0.25% to 5.25% to the consternation of UK investors, most of whom did not see this one coming.

Not only in the UK, but across the world, investors have been assuming that, supported by falling energy prices, inflation numbers would soon start to drop – a hypothesis which makes great intuitive sense.

Now, with the risk of getting someone's knickers in a twist, we will argue that in a service driven economy such as the UK, commodity prices matter surprisingly little. OK, they may lift consumer price inflation (CPI) from 2% up to 3% and back down to 2% again but, in the bigger scheme of things, that is not what matters[1].

The key drivers of inflation

There are essentially two drivers of inflation – unit labour costs and inflation expectations, the latter being relevant to the extent behaviour is impacted by those expectations[2]. If you expect a chicken to cost the same or perhaps slightly less tomorrow than it does today, you will happily settle for a salary increase of 2%. However, if you see prices rising all around you, you are more likely to dig your feet in and ask for a more radical pay rise to compensate you for the

---

1 *Should you wish to read a recent account of our view on inflation, go to the September 2006 issue of The Absolute Return Letter which you can find on www.arpllp.com.*

2 *In Woody Brock's aforementioned work, he lists four principal (structural) drivers of inflation which, between them, have greatly impacted both unit labour costs and inflation expectations in recent years. The four structural drivers are (a) rising productivity, (b) the decline in power of organised labour, (c) the rise of Asian outsourcing and competition (aka globalisation) and (d) improved monetary policy.*

deteriorating basket of goods that your salary buys. It is this mechanism that we refer to when saying that expectations are an important driver of inflation.

The global workforce doubles

Now, with the global workforce having virtually doubled in recent years from about 1.5 billion people to approximately 3 billion people (strongly aided by China, India and Eastern Europe joining the global economy), it is hardly surprising that behaviour has changed. You may want to ask your employer for a pay rise but, then again, he may turn around and make you surplus to requirement as moving production to Shanghai or Katowice is no longer the big decision it used to be.

As Richard Freeman pointed out in his August 2006 research paper 'The Great Doubling: The Challenge of the New Global Labor Market':

"The immediate impact of the advent of China, India and the ex-Soviet bloc to the world economy was thus to reduce greatly the capital to labor ratio. This has shifted the global balance of power to capital."

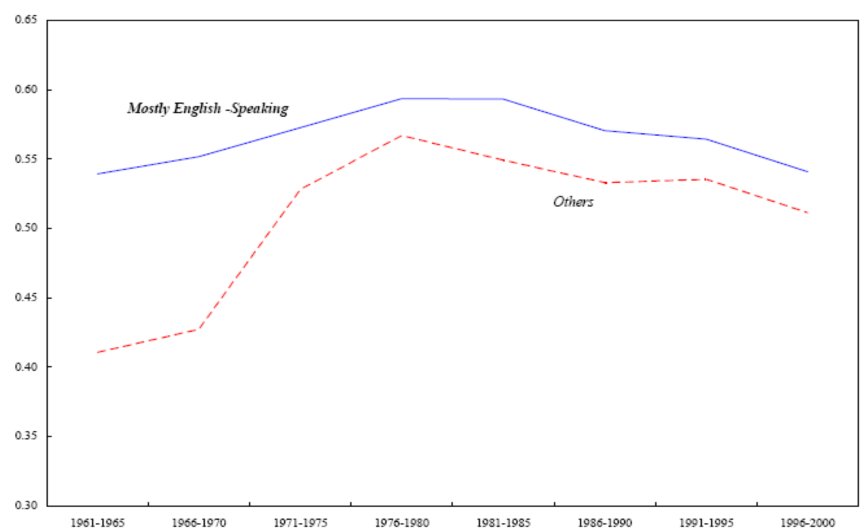
Absorbing them will take decades

He goes on to conclude:

"But even under the most optimistic scenario, it will take decades for the global economy to absorb the huge workforces of China, India and potentially other successful developing countries."

The effect Professor Freeman is referring to is illustrated in a new research paper from the IMF[3] which looks (amongst other things) at how labour's share of national income has changed in the last 50 years or so.

Chart 1:
Ratio of Labour Income to National Income in OECD Countries



Source: IMF Working Paper 06/294, December 2006

[3] *'Effects of Globalization on Labor's Share in National Income', IMF Working Paper 06/294, December 2006.*

Workers are losing out

As you can see from chart 1 above, workers increased their share of the pie throughout the 1960s and 1970s. Since about 1980, however, a smaller and smaller slice of national income has been going into the pockets of workers, which again is one of the principal reasons corporate profits have grown strongly in recent years.

It is often assumed that workers' loss of bargaining power is an Anglo-Saxon phenomenon and a result of the free market approach so strongly encouraged in our part of the world. However, if you look more closely at chart 1, it is obvious that workers in what are perceived to be more protected markets (Germany, France, Italy, etc.) have been subject to exactly the same trends.

Now, this is not exactly a new science. It has been known for quite a while that the force is no longer with the unions. The added competition of 1,500,000,000 workers from China, India, etc. has largely destroyed their bargaining power, or so goes conventional wisdom. It is called the unstoppable force of globalisation and many believe that inflation will stay low for many years to come for precisely this reason. Let's challenge this view.

UK wage negotiations underway

Production jobs are a great deal easier to outsource than service jobs, although we freely admit that many service jobs are exportable as well. In the UK, the next few weeks will thus be critical as wage negotiations get underway.

The British tradition is to use the retail price index (RPI) – not the CPI - as the basis for wage negotiations and, lo and behold, RPI jumped 4.4% as of the latest count. If companies give in and offer the average worker in Britain pay increases of 4-5%, we would be very surprised if the Bank of England doesn't respond with further rate hikes. Well, they may do it anyway given the recent trend.

Other European countries have wage negotiations coming up in the Spring and the story goes that it will be a bigger challenge than it has been for many, many years to keep the numbers down. We will see.

Expectations have changed

Rapidly rising energy prices combined with food inflation of over 5% have done considerable damage and workers appear far more likely to seek compensation for lost purchasing power now than has been the case for years. Meanwhile, the recent fall in energy prices has come too late to have a meaningful impact on expectations. The heating bill – a big component of people's budget - is still much higher when compared to a couple of years ago.

Consequently, we expect more pressure on wages and hence on unit labour costs – the latter because productivity enhancements are fading. For this reason we do not agree with some of the more bullish assessments of monetary policy for 2007. Do not be surprised if, at year end, rates in the UK and Euroland are above current levels. Even in the US, where a slowdown is currently unfolding, there is a chance that rates will be close to present levels – clearly not a consensus call.

The risk of inflation doing serious damage is still moderate, though. The continued and unabated force of globalisation will see to that. On the other hand, there are inflationary forces at play now which we haven't experienced for at least 25 years. This makes it a very risky proposition to lower interest rates at this stage.

Protectionism the biggest risk

Protectionism, on the other hand, is a risk we urge you to take quite seriously. In our view it is easily the biggest risk global markets will be facing during the next 12 months – in particular, if the global economy cools down.

Protectionism is a cancer which could kill the bull market. Equity markets have always preferred free market forces to interventionism, because history has taught us that free market forces do a much better job than politicians would ever be capable of. Unfortunately, that has never stopped them from trying.

A shift to the left

It is every voter's right to vote for those politicians whom he or she believes to be most sympathetic to their cause. And with the recent swing to the left in many countries, that seems to be precisely what is happening.

According to Stephen Roach at Morgan Stanley, who has written extensively on this subject over the past few months, recent political developments in France, Germany, Italy, Spain, Japan, Australia and the United States suggest a shift to the left on a global scale.

It is tempting to conclude that this trend is very much a function of voters having decided that enough is enough and that politicians must be empowered to face the rising challenge from Asia. And politicians are not slow in responding to the call.

Anti-China legislation on the rise

In US Congress, more than 25 pieces of anti-China legislation have been put forward in the past two years alone. Vote-seeking congressmen sense that Americans are increasingly tired of watching the Chinese (and other Asians for that matter) laughing all the way to the bank.

However, whereas we can only agree that the Chinese do not comply with even the most basic of fair play rules by not allowing the Yuan to float freely, we cannot endorse protectionist legislation which borders on stupidity.

What a choice

In France, where the line between politics and prostitution is very fine indeed, the two leading candidates to take over from President Chirac are both sucking up to the electorate with promises of increased protection(ism) for French industry. Please allow us to bring a few quotes from the candidate of ruling UMP party, Nicolas Sarkozy, who recently gave an interview to Les Echos, the leading French business paper, on the subject of globalisation[4]:

"It is one thing to lay off staff when one is facing bankruptcy and have no other choice and quite another to delocalize production in order to boost the share price."

"There is also in the US a law which guarantees small domestic companies a share of government contracts. I ask that we do the same in France and Europe."

"Let us ask ourselves whether putting a tax on imports to finance our welfare state, as a "social VAT" would do, could turn out to be a viable solution?"

We saved the best one for last:

"Between protection and protectionism, I want to find a middle ground."

Remember these words were spoken by a centre-right politician. God help us (or rather France) if Segolene Royal, the candidate of the socialist party, wants to go one better.

In the UK, despite the Labour Party suffering one almighty PR disaster after the other, the Tories have not yet managed to wrestle the political initiative away from Labour – perhaps another sign that the political pendulum all over the world is moving from right to left.

Our concern is not a shift in the political landscape per se. Politics is, and has always been, a business that ebbs and flows and there is no reason to expect that to change. However, it very much concerns us that politicians seem to be only too prepared to deliver what the mob wants.

Protectionism not the way forward

Protectionism is not the right way forward. Never has been, never will be. The fact that China is guilty of one of the greatest economic crimes of all times is no justification for increased protectionism. As long as the global economy strolls along, as it evidently does at the moment, the cries for increased protection(ism) are no more than distant drums, serving as a reminder of things to come.

In a recession the drums will get louder and louder until the pressure becomes too much to bear for our elected politicians and they give in. At that point, we would almost certainly have a nasty bear market on our hands.

Niels C. Jensen

4 *Aptly translated by GaveKal Research in a research paper named 'Read It and Weep', November 2006. See www.gavekal.com.*

Absolute Return Partners

Absolute Return Partners LLP is a London based private partnership. We provide *independent* asset management and investment advisory services globally to institutional as well as private investors, charities, foundations and trusts.

We are a company with a simple mission – delivering *superior risk-adjusted returns* to our clients. We believe that we can achieve this through a disciplined risk management approach and an investment process based on our *open architecture* platform.

Our focus is strictly on *absolute returns*. We use a diversified range of both traditional and alternative asset classes when creating portfolios for our clients.

We have eliminated all conflicts of interest with our *transparent* business model and we offer *flexible* solutions, tailored to match specific needs.

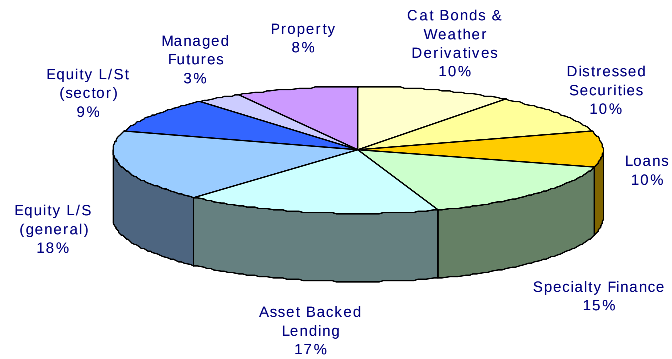
We are authorised and regulated by the Financial Services Authority.

Visit www.arpllp.com to learn more about us.

Absolute Return Letter Contributors

Niels C. Jensen	njensen@arpllp.com	tel. +44 20 8334 7020
Jan Vilhelmsen	jvilhelmsen@arpllp.com	tel. +44 20 8334 7021
Nick Rees	nrees@arpllp.com	tel. +44 20 8334 7022
Robert Dawson	rdawson@arpllp.com	tel: +44 20 8334 7024

The **Multi-Strategy Portfolio**
as at 31st December, 2006:



The **Millennium Wave Portfolio**
as at 31st December, 2006: