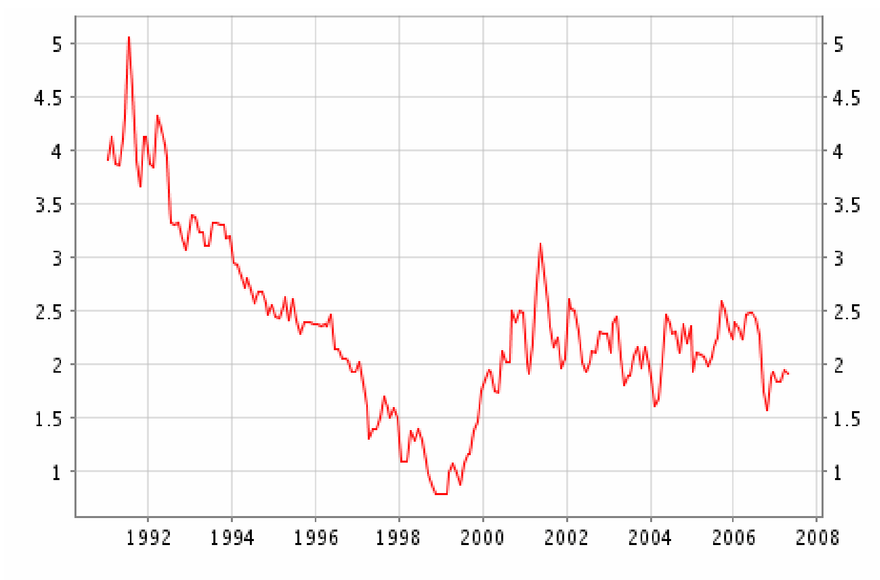
The Absolute Return Letter
June 2007

Cooking the Books

The chart that tells you nothing

There is no question that headline inflation in many parts of the world is currently enjoying some relief as the effect of rising energy prices a couple of years ago finally seems to have been washed out of the system. In this month's letter we will take a closer look at inflation and why it may be premature to celebrate. Let's begin by looking at how headline inflation in the EU has developed in recent years:

Chart 1: EU Harmonised Index of Consumer Prices.



Source: http://sdw.ecb.int/

We have chosen to entitle the chart the *EU Harmonised Index of Consumer Prices*. However, we could also have named it *"The chart that tells you nothing"*. You see, the inflation figures which form the basis of the chart (and similar charts in other parts of the world) are subject to almost endless manipulation. It is a little bit like the ongoing doping scandal in cycling. Pretty much everyone is guilty, but most people involved in the scam are arrogant enough to dismiss the allegations as nonsense.

Why the books are cooked

Why would they cook the books? The answer is simple: Money. Most government employed people are on cost-ofliving adjusted pay packages. Social security programmes, retirement programmes and pension contributions are all inflation-adjusted. Interest payments on national debt (which is very high in both the US and the UK) would go up dramatically if inflation was reported closer to its real level. In other words, there are billions to be saved if you can keep the official inflation figures down.

Manipulation is simple

Manipulating the numbers is surprisingly simple. Here is a brief summary of some of the most commonly used tricks[1]:

Elimination of goods and services where prices are rising rapidly – the best example is housing which has gone up tremendously in price in recent years. A couple of years ago the British government quietly eliminated the impact of housing inflation by switching from the retail price index (RPI) to the consumer price index (CPI) in the name of EU harmonisation. Surprise, Surprise. RPI has a substantial housing element; CPI does not.

Adjustments for quality improvements (but not for quality deteriorations) – the classic example is the computer price hike of 10% which is offset by the fact that the quality of the computer is judged also to have improved by 10%. Hence there is no impact on the CPI index. This is called hedonic pricing and is widely practised in the U.S but less so in Europe.

Substitution to less expensive goods – Sometimes, the men in black will simply assume that we consumers switch to less expensive goods when faced with price increases. The classic example is restaurant visits. If the price of your favourite steak jumps 10%, it is often assumed that you order something else instead - or perhaps go to a different restaurant. There is no question that in real life there is some level of substitution taking place every day. However, this little trick leaves room for almost endless manipulation.

Is US inflation running at 10%?

If you do not believe me, visit www.shadowstats.com. John Williams has made a career out of telling people the truth about inflation and other government statistics. He reckons that if you were to apply the same calculation methodology as in 1980 (which may or may not be fair), current U.S. consumer inflation is running close to 10% per annum – very similar to the levels reached around 1980 with the only difference being that the bond market back then was on high alert whereas now it appears very relaxed.

...and UK inflation at 7-8%?

You can also visit www.capitaleconomics.com – another company which provides independent research on the subject. Roger Bootle and his team reckon that inflation for

[1] *You can find a full account of this phenomenon on http://www.isil.org/towards-liberty/inflation-gov-lies.html*

the average UK middle class family is running at the highest level for many, many years, around 7-8% per annum.

Or you can simply take a look at the speed of which you part with your money these days compared to just a few years ago. What difference does it make that a fridge is cheaper than it was last year if we only buy a new one once every 7 or 8 years? What really matters is that a bigger and bigger part of our budget is allocated towards services and service prices are rising fast these days.

We also note that if it is correct that inflation is really running somewhere between 6% and 8% in the US and the UK (and probably at somewhat lower levels in mainland Europe), then both economies are actually in recession now[2]. I'd better keep this observation to myself, though, since I have a bet going with one or two people as to whether the US economy will hit recession this year or not (I am saying not).

You may argue that it doesn't really matter what we or anyone else thinks of the way the CPI index is calculated. What matters is what the broad market thinks. And we would be the first to concede that there is, indeed, a large element of truth to that argument. So let's move on to what is currently happening to food prices, because that may be really difficult to hide.

Prepare for higher food prices

Our friends at Bedlam Asset Management wrote a brilliant piece about a month ago called *"Nuns mug disabled orphan for bag of crisps"[3].* The essence of the article is that the world should prepare for *much higher* food prices. We strongly suggest you read it.

Unknown to many people, basic food prices have exploded recently. Rice, wheat and corn, three critical food stables, are all up between 45% and 65% over the past two years. Most people in our part of the world haven't really noticed yet because it takes time for price increases in basic food prices to filter through to the end products. But it is starting to happen. As recently as last week, Nestle warned that they could no longer absorb the underlying price inflation and would have to raise prices – in some cases significantly so.

Now, with the average consumer in the U.S. spending just over 6% of disposable income on food in the home, even a price increase of substantial proportions would probably not do too much damage to the overall budget. The same assumption can fairly safely be made when it comes to most other OECD countries even if they spend a somewhat higher proportion of their disposable income on food[4].

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[2] *Nominal GDP less inflation, also known as real GDP, would be negative for both the UK and the US if one used 6% inflation instead of the actually reported number.*

[3] *You can find the article on our website (www.arpllp.com) under Latest Postings.*

[4] *The difference between the US and other major OECD countries (as shown in table 1) would be significantly reduced if one were to include money*

However, when you look at some of the most populous nations on earth (China, Russia, India and Indonesia) an altogether different picture emerges (see table 1). 30-50% of disposable income is spent on food items in these countries. Food inflation of 10-20% or more would spell seriously bad news for most people in those countries. It could potentially even lead to civil unrest, not unheard of in those parts of the world.

Table 1: % of Disposable Income Spent on Food in the Home

United States	6.1%
United Kingdom	8.3%
Germany	10.9%
Japan	13.4%
China	28.3%
Russia	36.7%
India	39.4%
Indonesia	49.9%

Source: ERS/USDA.

Inflation expectations could rise

At the very least it will change inflation expectations (for the worse) in those countries. As we have noted before in this letter, changing inflation expectations can have quite serious consequences for the overall inflation level. It leads to demands for higher salaries with negative implications for unit labour costs unless neutralised through higher productivity and there is no assurance of that.

To begin with, markets will shrug off the news as a localised problem. The point not to be missed here, though, is that run-away food inflation could (and probably would) turn globalisation from being deflationary to inflationary. We have all grown accustomed to the idea that China and India export deflation. This is one of the fundamental building blocks upon which the current bull market is built.

Are central bankers tuned in?

Equally worryingly, central bankers in the western world who tend to base their forecasting models largely on domestic factors could suddenly find themselves behind the curve. In a recent paper published by the Bank for International Settlements[5], this very problem is discussed with the authors concluding:

"Global factors are becoming empirically more relevant for domestic inflation determination across a broad range of

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spent on food away from home as Americans spend considerably more on this than most other nations.

5 *BIS Working Paper No. 227 – "Globalisation and inflation: New cross-country evidence on the global determinants of domestic inflation".*

countries [...] questions could ultimately be raised about the very effectiveness of domestic monetary policy."

Only time can tell quite how serious this problem is. But those who dismiss rising food inflation as a non-event are at serious risk of digging their own (investment) grave.

Oil prices add to inflation risk

Next, we encourage you to consider the outlook for oil prices.

Five months ago, as we entered 2007, if we had told you that by early June:

a) the US economy would be flirting with recession;

b) the Americans and the Iranians would actually sit at the same table; and

c) oil inventories would be at or close to all time highs;

you would probably have projected an oil price below $50 (as most did). Yet, against all odds, the oil price has held up remarkably well with WTI trading at $64-65 as these lines are written. Long term readers of this letter will know that we have been bullish on oil prices for a long time. The resilience shown over the past few months has only reinforced that view.

Unless rising food prices do serious damage to global growth - and that is not entirely impossible - we would expect oil prices to begin the next leg of their journey north some time in the next 6-9 months as the US economy starts to gain momentum again. Behind this strength are four factors[6]:

1. Dwindling appetite amongst large oil companies to invest heavily in oil exploration due to increasingly inhospitable conditions in those areas where most of the oil is likely to be found;
2. Peaking of oil production in most of the large, established oil fields;
3. Lagged developments of alternative energy supplies;
4. Rapidly rising demand as more and more consumers in emerging markets join the middle classes.

The combination of 1 and 2 should worry you the most in the short term. If most of the large established oil fields experience falling production at the same time as Big Oil demonstrates limited appetite for investing in new projects, then the world is potentially facing a squeeze in oil supplies over the next few years. The recent decline in production at the second largest oil field in the world – Cantarell in Mexico – has shocked everyone. Now Iran is forecasting that, by 2014, it may not be able to export a single barrel. Again, this came as a major surprise.

2 billion to join the middle classes

These production problems happen at a time where more than two billion people in Brazil, Russia, India and China

[6] *Our observations on the energy outlook are strongly inspired by the latest work by Woody Brock (www.sedinc.com).*

(BRIC) line up to join the middle classes of this world. With middle class status comes car ownership and many other items consuming energy. Vast amounts of energy.

Even the Bush administration, which has not exactly been known for its attention to the world's energy problems, has realised the predicament of the current situation and has embarked on a fuel replacement programme which is largely based on turning corn into ethanol. There is only one problem. The Americans could produce ethanol at half the price if they were prepared to import sugar from Brazil. Now, they are making a few American corn farmers happy but at the cost of driving up food inflation with potentially devastating consequences.

To sum it all up, we could very well find ourselves in a situation where we are "damned if we do, and damned if we don't". Rising food inflation has the potential to kill off the economic boom currently enjoyed in most parts of the world outside Zimbabwe. In India, food inflation is already running at 10%. In China, the latest reported number is in excess of 7%. *The chart that tells you nothing* could suddenly tell an altogether different story.

$100 oil prices to come?

If, on the other hand, food inflation can be contained there are good reasons to believe that continued economic growth will force oil prices towards $100 per barrel (and possibly above) with depressing longer term consequences for inflation.

For that reason, we urge you to take the inflation risk seriously. Based on the evidence of recent market behaviour, though, equity investors are clearly not worried about these developments. Bond yields, on the other hand, have been creeping up in recent weeks. Do bond investors know something equity investors don't?

Niels C. Jensen

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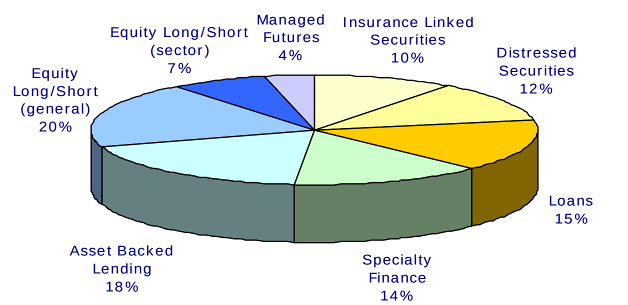
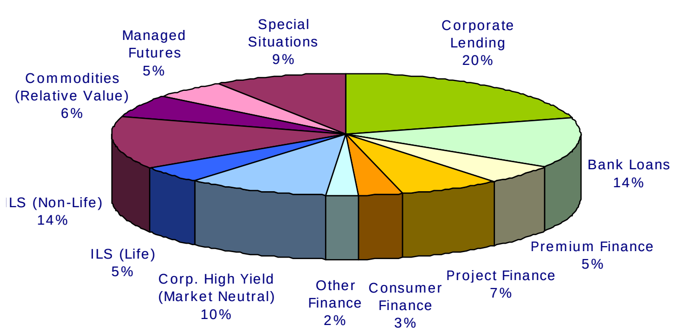
The **Multi-Strategy Portfolio**
as at 30th April, 2007:



The **Millennium Wave Portfolio**
as at 30th April, 2007:



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