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## Fund Manager Views

### High growth/Low inflation – Sustainable?



*Prudential Asset Management believes that with global inflation well under control, the outlook for the global equity markets is still positive.*

Before we begin, let us take a step back and look at the bigger economic growth/inflation picture.

During the 1970s to early 1980s, financial markets were confronted with a problem: how does one value equities in a high inflation, low growth environment? Investors found out the way after a period of trial and errors. Economies then moved into a period in which inflation, though lower, still remained high in relation to moderate growth.

But in the mid to late 1990s, there was yet another gear shift. This time, the global economy moved into a period in which growth was above inflation. Equity investors were thus faced with a dilemma: how does one value equities in a world that is diametrically opposed to that with which investors had become familiar?

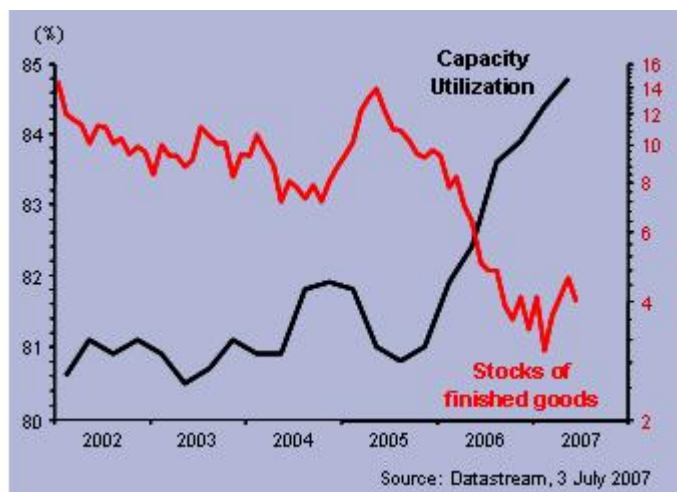
Unfortunately, investors never really got the opportunity to find out - for two reasons. First, demand for technology stocks took off in late 1998. Equity investors were thus focused on “getting it” valuing internet companies rather than coming to grips with valuing the new fundamental changes that were taking place.

Once the internet bubble burst, between 2000 and late 2003, the world returned to the familiar, in which inflation exceeded growth. The significance of the move towards a low inflation/high growth world was thus all but lost. “The low inflation world is a temporary phenomenon,” it was argued. The only problem was that it was not!

The result was that equity investors never really came to grips with pricing in a high growth/low inflation world partially because they really have never accepted that this kind of world could emerge on a sustained basis. They have always held the assumption that strong and sustained economic growth must ultimately feed inflation.

Well does it? Not necessarily, it seems. In fact, one can make the case that inflation globally, is under control. True, there are insulated instances in which inflationary pressures are evident. However, in Japan for example, “core” inflation still remains in negative territory.

Inflation fears seem unjustified



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### Changing environment

The reasons for this situation seem twofold. First, the emerging economies have distorted the “normal” economic relationships on which investors have based their strategic investment policies. The reason is: what these emerging economies want (such as raw materials) have gone up in price, what they produce (whether it is TVs or computer services) have gone down in price.

This emergence has thus created a situation in which commodity prices could soar while prices of goods and services could languish given the often extremely low production costs of the emerging economies.

“Ah ha!” our skeptics proclaim. “This situation cannot last. Signs of inflation are appearing.” The answers are, “True, true,” but it does not mean that the inflation cycle is turning. Not only because it would take high rates of inflation to significantly feed inflation but also because the advanced economies, especially U.S. and Eurozone, are on the verge of capital investment upturns.

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### Factories are running red hot!

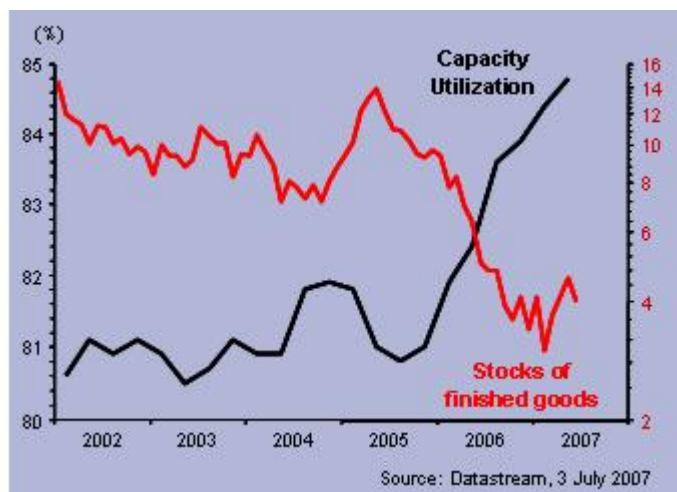
In the U.S., unmet orders in the pipeline are at record levels and factories are increasing their capacity. In fact, one can make the strong case that the U.S. economy, is on the brink of a “traditional” investment led growth cycle.

A similar situation exists in the Eurozone. Salesmen are depleting warehouse stock to rock bottom levels. As in the U.S., this situation could lead to higher inflation. But, as in the U.S., it appears that it will not - for much the same reasons; Eurozone factories look as though they too are at the start of a new investment cycle.

So, far from being at the start of a return to a slowing growth, rising inflation world, it looks as though we are entering the exact opposite - a world in which inflation is easing as growth accelerates. And that is precisely what the economists are forecasting for 2008.

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### Europe factories are working overtime



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### Equities face yet another speed hump

This has tremendous implications for equity investors, who, we believe, have not valued this kind of world. But in contrast to equities, the overwhelming message is that bonds may have “got it” - that inflation is not taking off.

True, bonds have retreated in the face of quoted inflation fears. However, yields, while rising, remain broadly where they were in 2002 when the bulk of the rallies ended. In short, they still seem to buy the view that inflation will not take off despite the inflation hype. If they did, we would expect to have seen a bond collapse given their historically high valuations.

This situation is highly significant in our view, as there is a massive on-going mispricing between bonds and equities. Either bonds are expensive and should sell off, or equities are cheap and should rally.

Equity investors have assumed that bonds have got it wrong, and why? Because equities have not absorbed the lesson that inflation just might not be taking off. Yet, this picture is precisely what is emerging.

If so, bond investors have “got it.” The inflation sky is not falling. It all suggests that equities have taken another faltering step towards what could be another strong sustained rally.

It is always difficult for one to get out of one's comfort zone and accept the changes that are happening around. The same goes for the critics and investors. News of falling liquidity, increased inflationary pressures and rising oil prices are just speed humps along the way of an equities rally.

Prudential believes that global inflation is well under control and is not expected to take off any time soon. Backed by strong growth, the outlook for the global equities market is still positive.

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