

# Inflation Bites

It's getting more expensive ...

Is your wallet getting lighter by the month? Does the weekly trip to the supermarket leave you reeling with a higher grocery bill and not much to show for it? Worse yet, do you feel the pinch of higher oil prices every time you stop to pump gas? Well, if it is any consolation, you are not alone. Everyone is feeling the shock of higher prices these days. The bad news is. "Get used to it"; higher prices are here to stay, at least for now.

But there is some good news; few economists anticipate a continued surge in prices. The consensus forecast for global inflation is to fall from 4.0% this year to 2.9% next year<sup>1</sup>. Even in the US, where stagflation talk is gaining momentum, inflation is forecast to fall from 3.8% to 2.4%.<sup>2</sup>

So while Joe Average is being swept up in a tsunami of rising prices, how can economists remain so sanguine? Clearly we live in different worlds! Yet, there is some solid logic supporting their view.

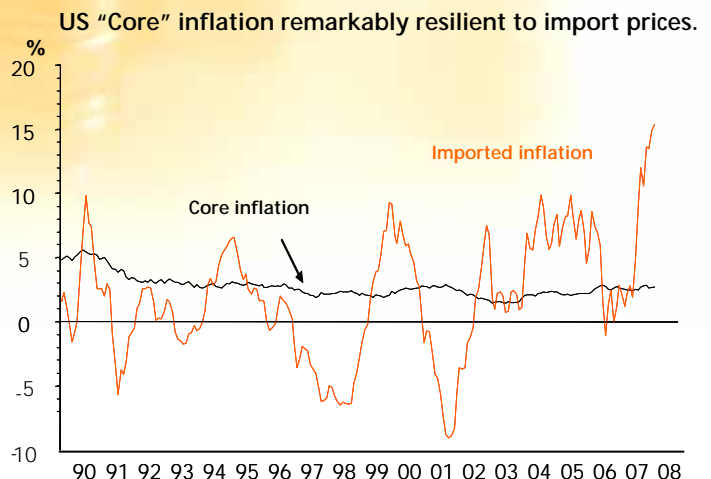
The weak US dollar, for example, has exaggerated the picture of real underlying demand. Most commodities are priced in US dollars; ipso facto, when the dollar falls, commodity prices rise. This is evident in oil prices that are trading at record highs of US\$130 per barrel - a rise of 110% since the start of 2007.<sup>2</sup> If that same barrel of oil is priced in Euros, the rise is a more "moderate" 78% - a large increase still.<sup>2</sup> Clearly, we must look elsewhere for factors underpinning the economists' more relaxed view.

A forecast moderation in world growth plays a major role in this belief. After growing at a blistering pace over the past few years, global growth is forecast to moderate to around 2¾-3% both this year and next.<sup>1</sup> Slower 2008 US growth (the consensus is 1.3%) should also restrict the ability of various producers to push through price increases to the end consumer.<sup>1</sup>

Clearly this will not be the case in some areas; those crushingly high pump prices readily spring to mind.

But few are forecasting price rises that will ripple through the wider economy. It seems unlikely that we are returning to 1970's stagflation era. At least that is what the statistics suggest.

**"Core" inflation appears contained**, Indeed, the much-feared feed-through effect of surging import prices is not as vicious as it seems.



Source of chart: Datastream, as at 6 June 2008.

<sup>1</sup> Source: Consensus Economics (London), May 2008.

<sup>2</sup> Source: Datastream, 9 June 2008.

Yet this fear was a major reason why the US Federal Reserve took inflation off the back burner. With US growth risks receding, Mr. Bernanke is fully aware of the dangers to consumer spending should prices climb further. That US consumer spending accounts for 70%<sup>2</sup> of GDP is not insignificant. The cost of getting inflation wrong, is high. (Asian central banks are also taking no chances, adopting a mix of policies to curb price rises).

The US Federal Reserve Board's recent moves seem rooted in the view "Why take the risk?" Although imported inflation has surged to 16%, inflation excluding energy is stable at around 3%.<sup>2</sup> With demand slowing, US businesses will have limited ability to push through price increases that will "stick". Where they have no choice – such as oil – we are already seeing the effects; sales of Hummers are falling as US buyers shift to smaller, more efficient Japanese autos. When seen in this light, the paradox facing economists becomes apparent.

### Shrinking liquidity pool

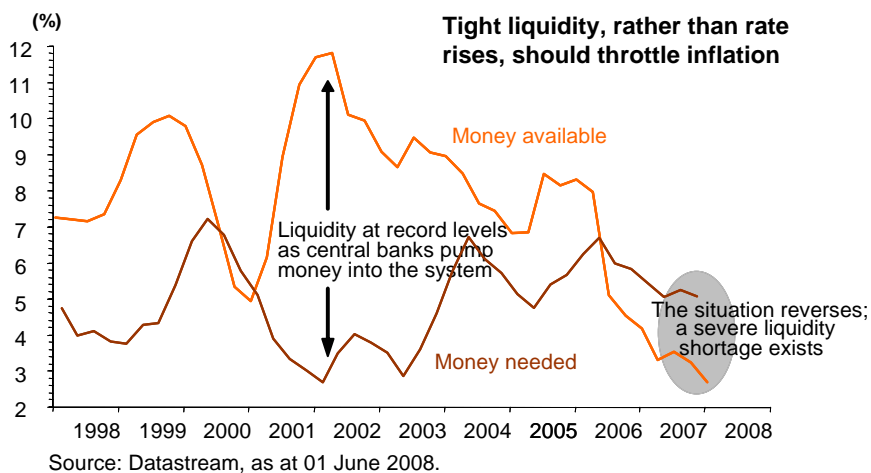
There, however, is a major constraint "out there" that will likely throttle inflation at birth and that is .....liquidity, or rather a lack of it.

A surge in global liquidity supply has long been cited as one reason for the inflationary surge already inherent in the system. Recall the massive liquidity build-up in the early 2000s as many central banks, but mainly the US Federal Reserve Board and the Bank of Japan, pumped money into their banking systems to offset the global economic slowdown. This liquidity not only found its way into a number of markets, including credit, housing, commodities and oil but also laid the grounds for a future money-induced inflationary surge, many feared.

In early 2006, the situation changed significantly. Although many central banks were still creating liquidity via their US dollar exchange rate policies, the ability of the lending banks to supply credit became severely restricted. Initially this was as various central banks stopped their cash injections, but more recently, bank lending has slowed as the US sub-prime issue has morphed into a generalized credit-crunch that restricted the ability (and urge) of the banks to lend.

In short, today there is a massive gap between the money needed to finance day-to-day activity (including price rises) and the money being provided by the world's banks. This largely unrecognized shortage will likely squeeze inflation out of the system.

Even if the larger picture does not spell disaster, the original dilemma remains; there will be inflationary "hot spots" especially closer to home in Asia.



China's inflation rate peaked in February this year. But subsequently March suggest the rise slowing especially as non-food inflation remains contained. This is a similar picture to that being painted in the US – underlying inflation is under control, but “hotspots” exist. Nevertheless, runaway inflation in China seems unlikely.

In fact the situation is pretty much the same across Asia, Malaysia being the only exception. Due to the government's fuel and food price subsidies, the economy has been relatively insulated from pricing pressures. But it remains to be seen how the recent removal of the fuel subsidies will impact the economy.

All told, global inflation will likely remain elevated in the near term due to high energy prices but eventually begin to ease as supply responses come through. Thereafter, inflation should stabilize but at a structurally higher level.

Nonetheless for our beleaguered shopper, facing the weekly rising grocery bill, all of the above will be rather academic. He or she can only find comfort in the fact that it really could be a whole lot worse.

Prudential remains defensively positioned across our range of country funds in view of the rising inflationary expectations and the likely monetary tightening measures. The funds' exposures to cyclical stocks (such as consumer related), have been reduced in favour of defensives (including telecoms and utilities).

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