

Inflation Outlook

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(The following views are those of the author and do not necessarily reflect the views of WellsFaber Asset Management.)

Setting aside inflationary shocks as a result of further, unexpected oil price surges, it would seem that global inflation has cyclically troughed, and we see the beginnings of an upswing in inflation, which naturally will eventually put upward pressure on interest rates.

There are two key global factors which will potentially add to inflation over the long term:

1. The degradation of sovereign balance sheets and the structural inflexibility of fiscal deficits.
2. The exporting of inflation by emerging markets to the developed world, as soft and hard commodity and labour costs increase.

In the near term, however, it is most likely that the majority, if not all, developed market central banks would rather err on the side of allowing inflation to rise above stated or implied targets during 2011, than raise interest rates significantly and risk stifling the nascent economic recovery that is occurring. There also remains excessive production capacity, especially in the USA, as well as continued high unemployment and very little increase in wages in real terms. These factors will temper the inflationary forces referred to above, at least temporarily, and therefore the likelihood of an increase in interest rates in the short term is not high.

That said, the US Federal Reserve is not blind to the dangers posed. The U.S. recorded annual headline inflation of 2.2% in February, up from the 1.7% rate seen in January (up 0.5% month on month). Core inflation also continued its climb, rising to 1.1% from a low of 0.6% in October last year. The key driver of the rise in headline inflation was commodity prices, but specifically energy prices - with energy up 11%. The US Federal Reserve stated in a release on March 15, that, "the recent increases in the prices of energy and other commodities are currently putting upward pressure on inflation," and that it would "pay close attention to the evolution of inflation and inflation expectations." Other regions too, are experiencing increases in measures of inflation. The Consumer Price Index in Brazil hit 5.91 percent in 2010, the highest level in six years. Russia's inflation reached 8.8 percent last year, while India just increased its inflation expectation for March from 5.5 percent to 7 percent. Europe has not been immune. According to European Union statistics, the inflation rate in the Euro area rose to 2.4 percent, the highest level since October 2008, and in April the ECB increased its interest rate by 0.25 percent.

Food Costs

Food costs are proving to be a concern. The latest edition of Food Price Watch, a research publication by the World Bank, showed that food price index rose by 15 percent between October 2010 and January 2011, is 29 percent above its level a year earlier, and is only 3 percent below its 2008 peak. The increases in these costs have been felt most severely in the emerging markets and developing economies.

World Bank Group President Robert B. Zoellick has warned recently that rising food prices are at dangerous level, cautioning that global food prices threaten "tens of millions of poor people around the world." Many

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political commentators have attributed the uprisings in the Middle East and northern Africa, at least in part, to these pressures. These uprisings have resulted in oil price spikes since January, which also increase inflationary pressures.

Oil

The effects of oil price increases are harder to predict, and are more dependent on the specific conditions of the economy in question. It is possible that the supply concerns resulting from the recent political turmoil in many Arab and northern African states will subside, leading to a decrease in the price. Of course, the reverse could also come to pass. However, overall, the recent rise in oil prices appears to be less of a concern at the current time than other inflationary pressures. Nevertheless, elevated oil prices will definitely have an impact. In South Africa, for instance, higher oil prices will act to lift CPI over the next two years. If oil prices remain at these levels, or increase, the CPI could average closer to 5 percent in 2011 and 6 percent in 2012. This could also have an impact on food inflation. The higher inflation trajectory should elicit rate hikes, possibly sooner than previously expected. Thus, while in the short term the SARB will likely focus on the country's benign core inflation path, and delay any hike until late into 2011 or early 2012, it is likely that we will see rate hikes in the next 12 months. The strength of the rand will also play a major role, as any significant weakness will increase these inflationary pressures.

Summary and Implications

While inflation is becoming a global theme rather than an emerging market theme, core inflation in most regions is still well under control, and economic growth and recovery remains the priority. In the short term the risks of significant global or domestic interest rate hikes seem low, but these risks increase the further out one looks. Therefore, government treasuries, especially medium to long-dated bonds, should be avoided, and one should, like the US Federal Reserve, pay close attention to inflation.