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Global Strategy Views

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By Carlos Asilis

Deflation Risks in the Developed World: Broad Global Macro and Market Implications

This report launches ITAÚ GLOBAL STRATEGY VIEWS, a bimonthly research series. In this series, we aim to address topical investment themes of interest to the global investment community. As our first focus theme, we have chosen the rising deflation risks in the developed world and the broad global macro and market implications.

Deflation Risks Sit at the Top of Investors' and Policymakers' Concerns

Over the past several weeks, the growing potential for a deflation scenario to unfold in the developed world over the next 1-2 years has come to occupy the top of investors' and policymakers' list of concerns, owing to:

1. the below-trend growth dynamics that have taken hold in the developed world since the second quarter of this year, and;

2. the still elevated levels of excess capacity in both output and factor markets – evidence of slack include excess housing inventories, excess industry capacity utilization levels, and elevated unemployment rate levels, among other factors.

Deflation touches a deep chord within economic policy and investment circles, given the painful memories associated with (1) the Great Depression period afflicting much of the civilized world during the 1930s, and (2) Japan's post-bubble economy in the aftermath of the bursting of that country's asset bubble (equities and real estate) in 1990.

Besides the inherent policy and market concerns associated with the length and depth of wealth destruction across those two periods, current policy and market concerns are exceedingly elevated, largely because of the scarcity of universally accepted policy lessons learned at the conclusion of such traumatic deflationary periods. That the Great Depression and post-bubble period in Japan have lapsed without the economics or finance profession generating a set of universally accepted policy lessons to draw on so as to forestall a recurrence of systemic deflation occurrences, is easily attested by the sharp ongoing policy debates, illustrated in today's media by the likes of Princeton's Paul Krugman, Gluskin Sheff's David Rosenberg and Soc Gen's Albert Edwards, whose views are placed firmly inside the systemic deflation camp, and others calling for a greater reliance on monetary policy tools, a position embraced by the University of Chicago's Robert Lucas Jr. and the Fed's Ben Bernanke (as well as European monetary authorities).

The absence of universally accepted policies in response to mounting deflation risks represents, in itself, an additional source of uncertainty for the markets and the economy, well beyond the risk associated with the price outlook (deflation, how much, how soon, how pervasive geographically, etc).

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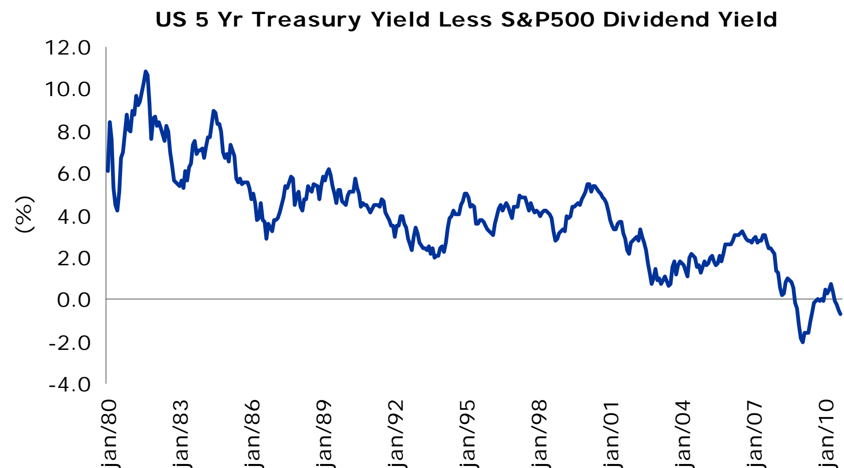
In that regard, as is well known by market participants, higher orders of uncertainty (economic and policy) are associated with higher levels of risk premia. Within the confines of the equities space, the latter takes the form of lower (than "normal") valuation multiples. One simple metric sufficient to illustrate such valuation compression may be found in the sharp narrowing between dividend yields and government bond yields over the past several months (Figure 1). Admittedly, a more adequate measure of rising risk premium nets out changes in long-term economic growth expectations for such spreads, as a component of the decline in the above-mentioned yield spread reflects developed market equities becoming "bond-like" as a result of lower long-term economic growth prospects in the affected geographies.

Figure 1:



Source: Itau Securities & Bloomberg

In this piece, our aim is to lay out the broad contours of the uncertainty surrounding a deflation scenario in the developed world. Specifically, we aim at answering the following questions: (1) are all deflation episodes created equal? (2) Do differences in macro backdrop matter and why? (3) Does the length of deflationary episodes matter? (4) How useful and relevant can policy response be in reaction to the onset of deflation? (5) What, if any, are the risks of deflation dynamics extending out of the developed into the emerging markets world? (6) What are the broad implications of deflation dynamics on equities and other asset classes? (7) What are the implications of rising deflation risks on portfolio construction?

In trying to answer the above questions, we do not purport to provide comprehensive or conclusive answers but rather offer insights into the nuances coloring each particular aspect of the "deflation" question, especially from a market perspective.

Price Dynamics, Always a Focus Area for Macro Policy and Markets

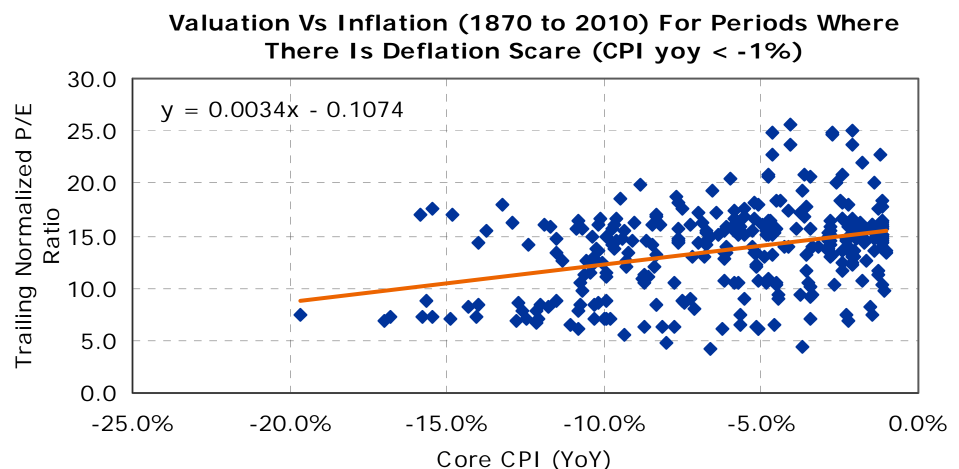
The direction of an economy's broad price trends, entailing either deflation or inflation, is always of interest from a macro and market perspective owing to multiple considerations, including, among others: (1) vastly different effects of inflation and deflation on households' purchasing power and standards of living; (2) vastly different effects of inflation and deflation across creditor and debtor groups within a society; (3) adverse effects of inflation and deflation on risk premia, especially at sufficiently high inflation levels and sufficiently low deflation levels; (4) adverse effects on the economy and earnings resulting from the historically documented inclination of governments to take on forceful policy actions in response to mounting inflation or deflation risks, often at the cost of damaging an economy's efficiency levels.

Price Dynamics Carry Distinct Implications on Asset Pricing Trends

At the market level, price dynamics carry distinct implications for the following asset classes depending on whether inflation or deflation risks dominate:

- Yield curve movements – steepening under modest inflation; bull-flattening under deflation.
- Asset valuation multiples – compression under deflation and high inflation; expansion under moderate inflation – Figure 2 below illustrates the deleterious effect of deflation on equity earnings multiples for the benchmark US large cap benchmark index – S&P500 – specifically, the figure shows 5-year trailing earnings adjusted P/E multiples average 13.7 times during periods of below 1 pct deflation as compared with a 16.3 times multi-decade historical valuation average.
- Currency dynamics – appreciation under deflation (and high real interest rates, as is commonly the case) and depreciation under inflation (and low real interest rates).
- Relative performance between cyclical versus defensive sectors of the affected country's equity market – cyclical underperformance under deflation and outperformance under moderate inflation.
- Relative performance between fixed income and equity assets (real estate being a hybrid of the two) – fixed income outperformance under deflation and the opposite under inflation.

Figure 2:



Source: Itau Securities & Robert Shiller (Yale School of Management)

Current Deflation Concerns Hinge on Both Structural and Cyclical Considerations

Recently, deflation concerns in the USA and Europe surfaced in 2008, in the aftermath of the financial crisis that paved the way for the ongoing period of stagnation that has become known as the Great Recession. At its root, these concerns hinge on the potentially potent deflationary dynamics that may take hold in economies, such as those in the USA/Spain/UK/Ireland, that have embarked upon what may prove to be a multi-year deleveraging phase of unprecedented proportions by the household sectors.

Under the above interpretation, the inevitability of such a deleveraging process finds its root cause in the burst of asset (primarily real estate and credit market) bubbles in 2007, whose genesis can be attributed to a misguided, overextended period of monetary largesse on the part of central banks, led by the US Federal Reserve. Such an easy monetary policy stance paved the way to a long period of below-equilibrium real interest rate levels that fueled a massive leveraging of household balance sheets.

The above mentioned structural dynamics are sometimes referred to as the balance-sheet nature of the adjustment that will be required to exit the Great Recession era. We include ourselves among those who expect such structural dynamics to significantly condition the ability of developed countries to restore growth to trend levels. However, we do not include ourselves among those who believe that such structural growth dynamics necessarily seal a systemic deflation outlook in the developed world. As a point of

reference, we define systemic deflation scenarios as those in which deflation lies below -3 pct on a sustained basis over a period beyond a year.

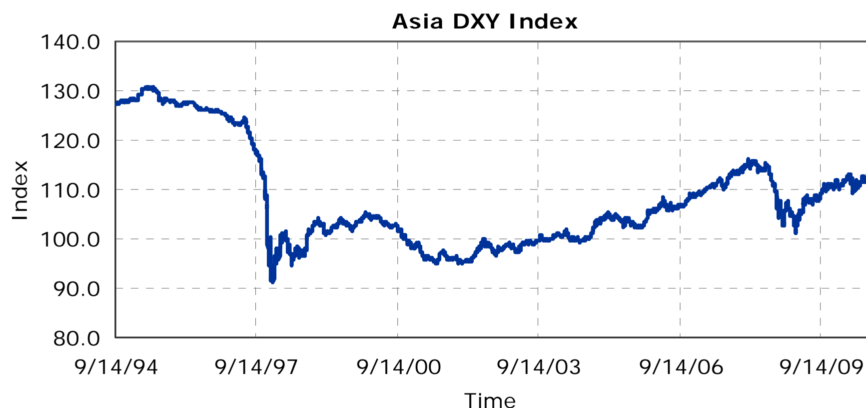
We differ from those who take on the systemic deflation view largely on account of our more constructive stance as regards the (a) ability of monetary policy to successfully meet the deflation challenges when the nominal policy interest rate hits the zero bound and also (b) the presence of offsetting (to deflation) price dynamics likely to emerge over the next several quarters, through the following channels:

1) currency markets (a weaker US dollar, especially versus emerging market currencies; there are already significant signs of cost push inflation emerging from Chinese exports to the rest of the world);

2) lower productivity growth levels in the USA and Europe (inflationary through the unit labor cost route, by far the most important driver of overall headline inflation in the developed world, especially in the USA), and;

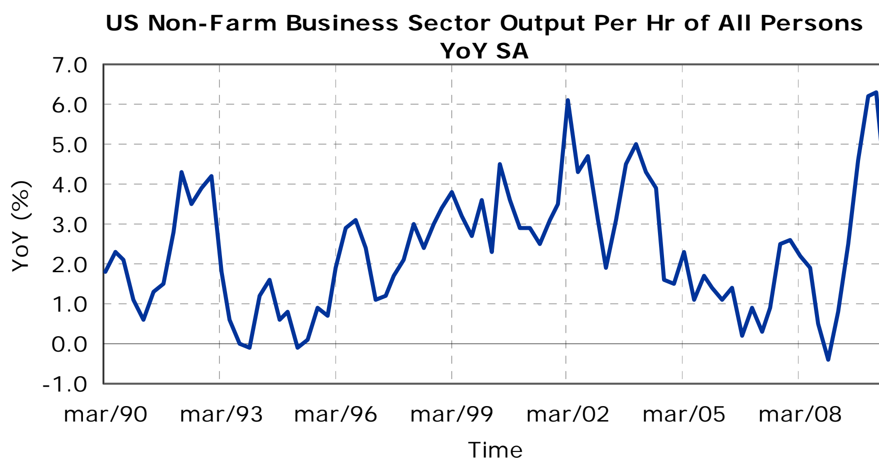
3) favorable cyclical backdrop (especially fueled by strong economies in the emerging markets world whose global GDP and trade shares continue to rise dramatically, doubling and even tripling for certain commodity groups and national markets versus levels of only eight years ago!).

Figure 3:



Source: Itau Securities & Bloomberg

Figure 4:

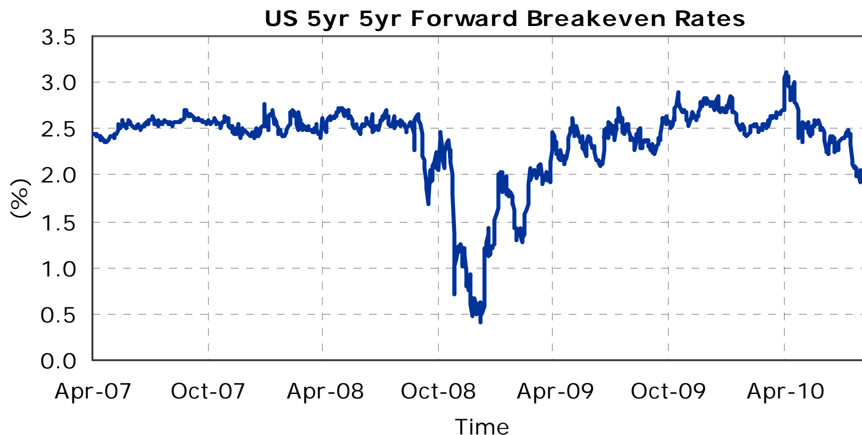


Source: Itau Securities & Bloomberg

Undoubtedly, the price outlook becomes far more challenging, as regards the risks of deflation, in instances, such as the period starting during the second quarter of this year, in which the cyclical backdrop weakens notably. In this regard, the market's growing concerns about deflation risks, fueled by structural factors, being reinforced by a deterioration of the cyclical backdrop is a real one (as illustrated in the sharp declines

recorded in 5-year 5-year forward inflation breakevens, in Figure 5), owing much to the following string of macro developments since the second quarter:

Figure 5:



Source: Itau Securities & Bloomberg

- China's fiscal and monetary policy tightening – please see e.g. Figure 6;
- The certainty of incremental fiscal policy tightening going into 2011, especially for the US and UK (to result in detraction from 2011 real GDP growth to the tune of around 1 pct);
- Weakening domestic demand (final sales) growth in the US and UK since the second quarter;
- Persistently low levels of consumer and business confidence in the US and Europe – weak demand for capital and final goods (reflected in still-rising household savings rates);
- Persistently weak labor market conditions in the US and the Euro area – weak demand for labor.

Figure 6:

Source: Itau Securities & Bloomberg

Such developments strongly suggest that the private sector is not yet able to fully take on the "passing of the growth baton" from the public sector. As such, those economies undergoing steady deleveraging dynamics and also scheduled to face incremental fiscal policy tightening in 2011 (such as the USA and UK) are most at risk of entry into a double-dip recession scenario. That some of the affected countries, such as the USA, are facing or have just faced legislative elections in 2010 has only exacerbated the uncertainty surrounding the economic outlook for 2011.

"The Devil is in the Details": Systemic-Deflation Cassandras Ignore the Record - Depth and Length of Deflation Requires Deep Productivity Shocks, None of Which Loom on the Horizon

We include ourselves among those who expect moderate deflation dynamics to take hold across several developed countries through parts of 2011 and possibly 2012, owing to the combined effects of structural deleveraging dynamics as well as a below-trend cyclical backdrop. However, we vigorously disagree with those who call for elevated risks of deep or lasting deflationary dynamics. We contend in the balance of this section that such a "systemic deflation" view (e.g. Princeton's Krugman, Societe Generale's Edwards, Elliott Wave's Prechter, among others) ignores the historical record as well as the major structural differences between today's international trade and monetary system and those prevailing during the 1930s, the only period in which deep, lasting deflation obtained.

Of necessity, taking sides in the "systemic" versus "cyclical" deflation debate represents an unavoidable proposition to any investor worldwide, large / small, institutional / retail as the market implications vary deeply across each side of the debate. As noted, we place ourselves firmly within the "cyclical" deflation side of the debate.

Our "cyclical," non-systemic deflation view is grounded on four principal considerations, further elaborated below:

- The statistical relationship between deflation and economic activity;
- The distinct role played by the unwinding of the Gold Standard and the absence of a lender of last resort in the onset of the "systemic" deep and lasting deflation of the 1930s;
- Keynesians' overplaying their hand as to the greater potency of fiscal over monetary policy in preventing the onset of systemic deflation; and
- Major structural economic differences for the US and Europe between the only period of "systemic" deflation in history - the 1930s - and the present make those regions significantly less susceptible to the deflationary effects resulting from the potential recurrence of the massive policy mistakes made in the 1930s.

We address each of these considerations, in turn.

1) On the statistical relationship between deflation and economic activity. One of the main tenets embraced by the systemic deflationists is that of the linkage, presumably of a causal nature, between deflation and economic performance. Specifically, the systemic deflationists constantly press the message that entry into deflation will necessarily lead to a sustained contraction of economic activity, which means recession or possibly depression. An examination of the statistical basis behind such a claim renders an unambiguous rejection. Specifically, the most authoritative review of the statistical evidence between deflation and economic activity is that of Andy Atkeson and Pat Kehoe (2004), entitled "Deflation and Depression: Is There an Empirical Link?", Federal Reserve Bank of Minneapolis, Report 331, 2004. The authors examine a sample covering 15 countries over 100 years, at five-year intervals. While the record includes a number of episodes in which countries experiencing deflation also suffered depression, the authors found far more instances in time when countries recorded economic growth alongside deflation. Thus, the empirical link between deflation and depression is vacuous.

2) The distinct role played by the unwinding of the Gold Standard and the absence of a lender of last resort in the onset of the systemic, deep and lasting deflation of the 1930s. Endorsers of the systemic deflation outlook, in their inability to anchor their views on the body of empirical evidence (as per point 1 above), often resort to referencing the only instance in which deflation was accompanied by contraction (including depression phases), namely the Great Depression of the 1930s. In their effort to flesh out a credible thesis as to why today's Great Recession carries significant similarities to the Great Depression period, thereby justifying the sole reference to the 1930s period for the purpose of drawing suitable policy actions, the endorsers of the

systemic deflation view allude to two principal considerations: (a) the hypothesized inability of monetary policy to function at the zero interest rate bound, and (b) the potential for uncontrollable, immeasurable deflation expectations to take hold on the back of insufficient demand conditions for goods and services. We address the former point (a) further below, while point (b) is addressed immediately.

Systemic deflationists' contention that an escalation of uncontrollable deflation expectations could lead to deep recession dynamics, possibly depression, is correct only because it is a tautology – as deep deflation implies, of necessity, collapsing demand conditions and therefore a collapse in output (in equilibrium). It is also true that the Great Depression period unfolded largely because of the escalation of uncontrollable deflation expectations. However, to base one's systemic deflation outlook on a tautology and an unqualified account of the single episode in history in which deflation attained depressed deflation levels, thereby coexisting with depression, represents, in our humble opinion, an argument much lacking in scientific rigor.

Our claim that systemic deflationists' allusion to the Great Depression period as the most relevant time window with which to compare today's global economy as "unqualified" is based on the distinct structural characteristics defining the 1920s and early 1930s global economy, ones which are totally absent from today's global economy and financial system. Specifically, a close examination of the fabric defining the 1920s and early 1930s global economy and financial system points to three characteristics that played a massively important role in the onset of severe deflation and economic depression, none of which are present in today's global economy and financial system: (a) absence of deposit insurance; (b) absence of lender of last resort, and arguably most importantly; (c) the Gold Standard as the basis for the international monetary system.

Of the three distinguishing characteristics defining the global economy and financial system of the 1930s, the Gold Standard stands by far as the most significant in placing the seeds for the onset of deep deflation and depression. Under such a regime of fixed exchange rates, countries were interconnected in a way in which shocks impacting one country would be quickly transmitted to others. Under the Gold Standard's fixed exchange-rate system, policymakers lacked the most important policy instrument: independent monetary policy. The failure of Creditanstalt, the largest bank in Austria, in June 1931 set the stage for a financial panic that morphed into a financial crisis in Germany as deposit flight took hold, with demand for gold surging as a result. Such a financial event unfolded against the backdrop of a global recession (without deep deflation) in 1930, on the heels of the Crash of 1929.

The lack of an independent monetary policy prevented countries from embracing a first-best policy response via the provision of additional liquidity demanded by the private sector as a result of concerns fueled by bank failures and the accompanying deposit flight. That Britain and other sterling bloc countries decided to part ways with other Gold Standard member countries and exit the Standard in September 1931, thereby allowing a significant depreciation of their currencies versus Germany's and other countries that stayed under the Standard, further aggravated the limitations conditioning German and other countries' policy options.

In response to Britain's and other sterling bloc countries' "straying from the pack" of the Gold Standard "Club," trade protectionism and exchange controls, adopted in late 1931, were perceived to be the path of least resistance or "sole option" by Germany and other countries that decided to stay inside the Gold Standard until 1935 and 1936 – for reference, the USA exited the Gold Standard in April 1933. Unsurprisingly, countries that exited the Gold Standard in 1931 experienced a relatively mild recession. In contrast, countries that clung to the Gold Standard until 1935 and 1936 experienced a prolonged economic downturn, a depression. In short, an examination of the historical record shows that exchange controls, trade protectionism and currency devaluation (through the exit from the Gold Standard) during the 1930s should be viewed as substitute or competing policy instruments, of course tied to vastly different economic outcomes.

In the above account of the 1920s and early 1930s European and US economies under the Gold Standard, the anatomy through which deflation expectations escalated in an uncontrolled manner and fed back into the real economy is easy to understand once one takes into account the absence of a lender of last resort and deposit insurance during that period. In offering such account, it is helpful to draw reference to the path of economic performance during that period. First, in 1930, US real GDP contracted by 9.3 pct, while the country recorded 4 pct deflation. Despite such significant contraction, bank deposits contracted by only 4.7 pct. The onset of the financial crisis in Europe, triggered by bank runs and the collapse of trade triggered by the imposition of exchange controls and trade protectionism, in turn fueled by the tensions associated with the exit of Britain and other sterling bloc countries from the Gold Standard, sealed the escalation of deflation expectations. In that manner, in the USA deflation levels touched 8.8 pct and 9 pct in 1931 and 1932, while the economy contracted 8 pct and 14.1 pct in 1931 and 1932, respectively.

In other words, an examination of economic performance during that period shows the crucial role of the three above mentioned characteristics in bringing about the unhinging of price expectations, paving the way for deflation and depression. Depression dynamics were coincident with the collapse of world trade, credit intermediation and liquidity shortages during that period.

In summary, we believe a careful examination of the 1920s global economic and financial system backdrop to the Depression years points to three critically important characteristics, all of which are absent today, that resulted in the propagation of financial shocks (e.g. failure of Austria's Creditanstalt and bank failures in the USA) into dynamics (protectionism, overly restrictive monetary policy - as per the limitations on monetary policy imposed by the Gold Standard and escalation of deflation expectations – owing to the absence of lender of last resort and deposit insurance) that are characterized best as massively adverse productivity shocks. As per the vastly different characteristics of today's global economic and financial system (presence of lender of last resort, flexible exchange rates – except within the Eurozone, presence of deposit insurance), the reproduction of such pernicious propagation mechanisms fueling deep deflation and depression are exceedingly unlikely to obtain in today's global economy, in our humble opinion.

3) Keynesians' overplaying of their hand as to the presumed greater potency of fiscal over monetary policy in preventing the onset of deep deflation. Arguably, the key presumption made by notable Keynesians and neo-Keynesians alike, many of whom endorse the systemic deflation outlook, is that monetary policy is rendered ineffective at the zero interest rate bound (as nominal interest rates can only be zero or positive). As such, by logic of elimination, Keynesians argue that fiscal policy becomes the focus area for policymakers in their task of engineering a recovery or at least the avoidance of systemic deflation. As substantiation for the opposing viewpoint, we lay out the following considerations, many of which have been outlined by equally respected economic professionals, including the University of Chicago's Robert Lucas Jr., as those populating the systemic deflation camp:

(a) deflation is a concern to those who think of monetary policy purely in terms of interest rate control. The historical evidence is clear as to the potency of money supply control. We need not go back to the contributions of Friedman and Schwartz, covering the role of monetary and banking policy in planting the seeds for the spiraling of an initial recession into a depression, characterized by deflation. It suffices to look back to the Bernanke Fed's response to the deflation scare that flared up at the end of 2008, in the aftermath of the Lehman Brothers collapse.

(b) The Bernanke Fed's and Bank of England's late 2008-2009 response to the Lehman Brothers collapse is a highly meaningful recent example of the effectiveness of quantity-based monetary policy as a means of forestalling the unwinding of deflation expectations. Specifically, the massive and sudden surge in the Fed's balance sheet over the last several months of 2008 proved crucial in anchoring generalized price expectations by helping put a floor under asset prices directly impinging on the banking system's balance sheets, in the first instance, and indirectly on the balance

sheets of non-financial corporates.

In the above, it is important to note that the Fed's and BOE's aggressive money supply response on the heels of the 2008-2009 deflation scare, with the Fed effectively putting more than $ 600 billion of new reserves into the private sector in the last four months of 2008 alone, stand in stark contrast to the inaction of the 1930s developed country central bank authorities (again, largely the result of the restrictions imposed by those countries' allegiance to the Gold Standard) and 1990s Japan. Through their decisive actions in 2008 and early 2009, the Fed and the BOE exercised quite boldly their lender-of-last-resort function. By contrast, during the 1930s, the Fed and other central banks were unable to exercise such a role. As importantly, looking ahead, there are no restrictions in preventing central banks from further extending such quantity-based monetary policy actions.

(c) Systemic deflationists' exclusive focus on the zero (nominal) Fed Funds interest rate bound ignores the existence of thousands of interest rates throughout the financial system, upon which money supply actions carry important impact. Once again, the recent end-2008 Fed and BOE policy responses provide an illuminating example of the potency of money supply actions on the determination of thousands of interest rate levels. These, in turn, carry important stabilizing effects on inflation expectations directly and also indirectly through the supportive effects on the real economy stemming from the application of aggressive actions on the money supply.

(d) Recourse to monetary policy is vastly superior to fiscal policy on one additional metric: it is far easier to decide and implement the quick withdrawal of monetary stimulus over an equivalent-sized dose of fiscal stimulus. Moreover, as the history of the 1930s teaches us, the adoption of restrictive fiscal policy actions (including trade protectionism) can take decades to reverse – in fact, many of the trade restrictions imposed in the early 1930s were not removed until well after the end of the Second World War. Thus, from a risk-management perspective, monetary policy is a lot safer than fiscal policy, as the speed and political cost of unwinding any exaggerated application of stimulus is more favorable on all counts.

4) Major structural economic differences in the developed world between the only period of systemic deflation – depression (the 1930s) and the present make those regions significantly less susceptible to the deflationary effects stemming from the hypothetical recurrence of the massive policy mistakes made in the 1930s. In this regard, we are alluding to the massively larger share of the labor force tied to international trade during the 1930s as compared to today. For example, in the USA such a share amounted to around 45 percent of the total labor force (in sectors such as agriculture, mining and manufacturing), compared with around 13 percent today. Thus, the effects of a similarly-sized productivity shock (stemming from the application of trade restrictions à la 1930s) on output and price dynamics in today's US economy would be several orders of magnitude smaller than what obtained in the 1930s. As is well known by most observers, today's US and European economies are predominantly service-sector-based.

Principal Risks to our Moderate, Non-Systemic Deflation Thesis

At this juncture, the reader may rightly question the risk of our thesis being proven wrong and systemic deflation dynamics ultimately taking hold in the developed world. From the above discussion, in which we provided historical and theoretical context to the systemic deflation risk scenario – already establishing that for moderate deflation, the body of empirical evidence does not show a robust relationship between deflation and economic performance – we attribute the risk of recurrence of a Great Depression deflation phase as virtually close to zero or very near to zero.

For us to embrace a significant probability weight to the systemic deflation scenario, we would have to admit an equally large probability of systemic problems surfacing throughout the international financial system, inclusive of large-scale bank failures and bank runs. We are unable to attach a high probability weight to such scenario for the international financial system on account of the vast array of institutional arrangements

already established between the world's major central banking institutions as well as the unprecedented money supply actions taken in the aftermath of the Lehman Brothers collapse in 2008. As regards the risks surrounding a shift in central banks' continued reliance on monetary policy actions, we are unable to detect any measurable risk of such a policy reversal in either the willingness or ability of the world's largest central banks.

Broad Market Implications From a Moderate Deflation Outlook

As per the above discussion, we expect the intermediate-term outlook for the developed economies to be one of below-trend but still positive economic growth with significant risk of moderate deflation in the developed world over the next 1-2 years. As regards any potential contagion from said moderate deflation dynamics in the developed world into the emerging markets, we expect none.

We hold such expectation as regards the absence of deflation contagion risks from developed into emerging market countries on the basis of the absence from today's global economy of structural conditions historically responsible for cross-border deflation effects to obtain, largely via the presence of rigid fixed exchange-rate regimes à la Gold Standard of yesteryear. Moreover, international trade and financial linkages are far more intertwined across countries today than they have ever been, both via the formalization of international trade and financial agreements – including the presence of international financial coordination protocols – as well as through the metamorphosis experienced by multinational companies hailing not only from developed but also emerging market countries. Specifically, the modern multinational company embodies horizontal and vertical integration phases that cut across multiple, at times in the tens, national geographies. This architecture of the modern multinational company significantly lessens any temptation by developed-country governments to employ trade policy as a competitive policy tool, one that in the 1930s resulted in the export of deflation dynamics across borders.

From an investment perspective, the above suggest the following factors as overweight in any global portfolio:

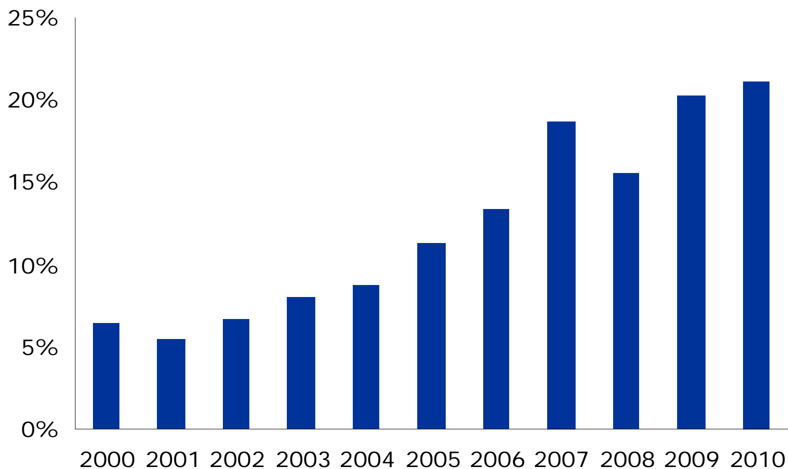
- Within global equities, overweight exposure to emerging markets and emerging market-plays within developed countries (that is, developed-country companies with primary revenue exposure to emerging market consumers and firms). For reference purposes, the accompanying Panel 1 (on the next page) illustrates emerging market equities' compelling investment case versus their developed market peers, across the valuation/revenue/margin and ownership momentum divides.

- Within global fixed income, overweight exposure to credit over government bond instruments. Within credit in the developed world, we favor high-quality sub-investment grade over investment grade paper on account of more attractive risk-adjusted returns. Also in the developed world, we favor bull-flattening strategies. Within the emerging markets world, we favor corporates over sovereign paper, with a greater emphasis on Latin America local currency instruments, especially Brazil and Mexico.

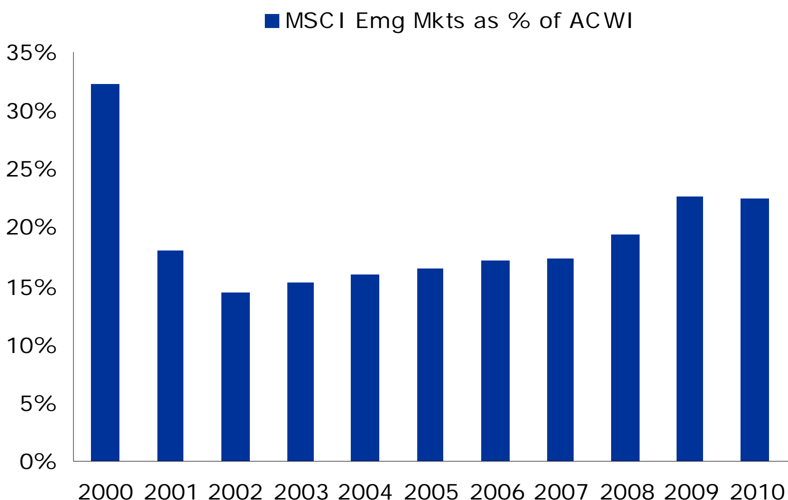
- Within the currency space, overweight exposure to emerging market currencies of countries with solid fiscal fundamentals, well-diversified (preferably inward-growth-oriented) policies and growth dynamics. In practice, most of the countries meeting such criteria are found in Asia, the Middle East and select Latin American countries.

- Within the commodities group, we favor a barbell exposure to agriculture and industrial commodities over precious metals or energy, on account of the clearer secular trends underpinning demand for agriculture and industrial commodities. As regards gold, we are not keen on the commodity on a stand-alone basis but admit the desirability of holding exposure to the precious metal in light of the desirable risk-diversification effects, given the prospects of deflation (albeit modest) and continued fiscal indiscipline in the developed world.

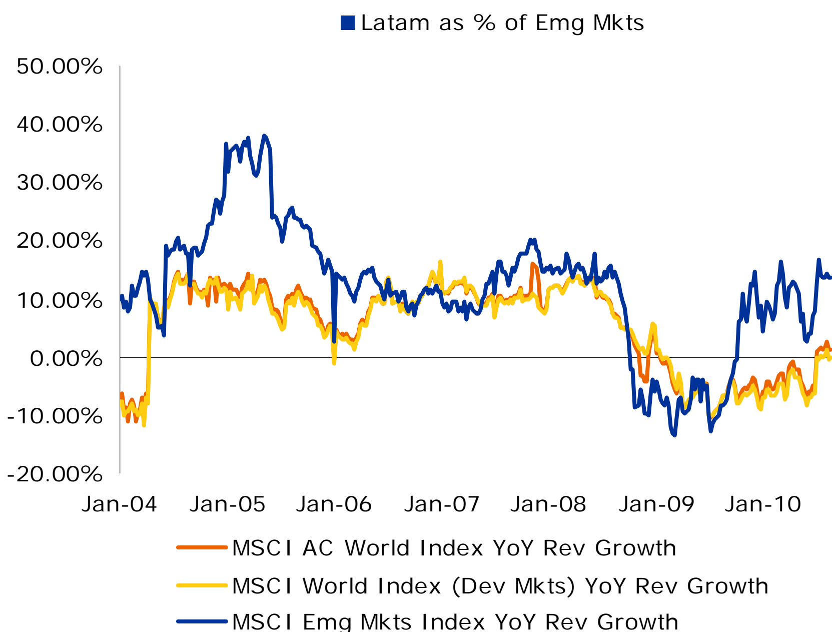
Panel 1: Emerging Market Equities — Valuation and Growth Comparators versus Developed Market Peers



Emerging Markets command an increasingly larger share of world market stock capitalization.

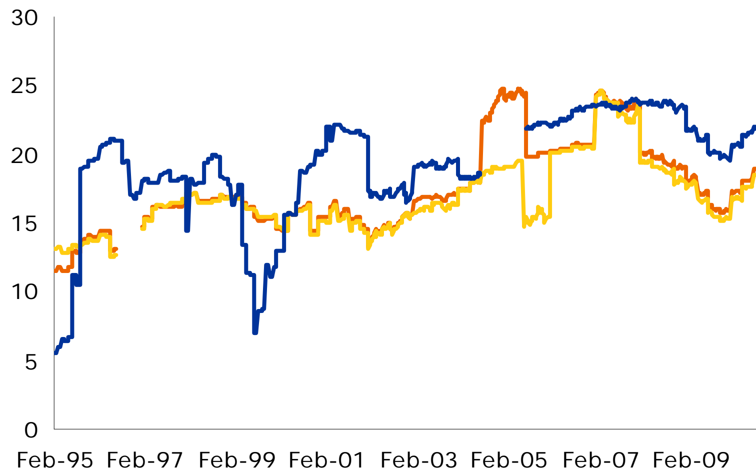


Within the emerging markets universe, Latin American equities represent an increasingly larger share of overall market capitalization.

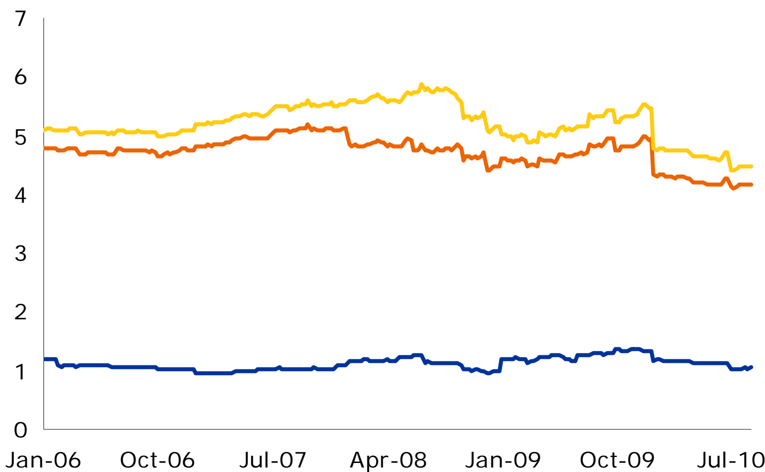


Emerging markets' compelling investment case, versus developed market equities, takes the form of stronger revenue growth as well as...

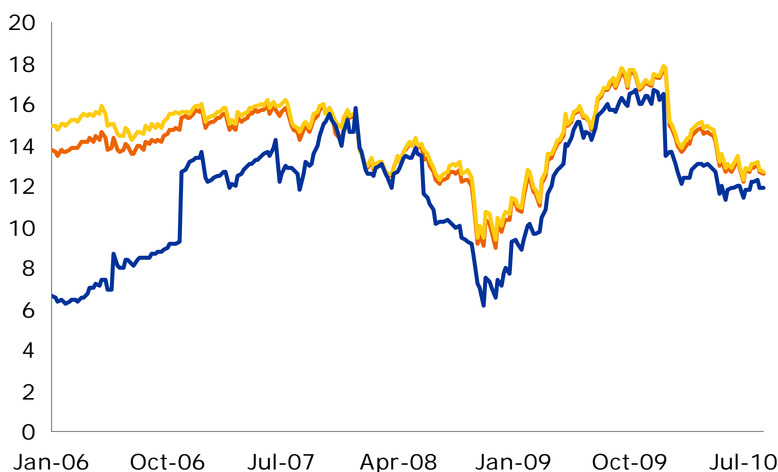
Panel 1: (cont'd) Emerging Market Equities — Valuation & Growth Comparators versus Developed Market Peers



...firmer operating margins,



...stronger credit fundamentals, and...



...still trading at about an 8 pct P/E valuation discount to developed market equities.

Source: For all charts on the two preceding pages, Itaú Securities, MSCI and Bloomberg

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