Global Strategy Views

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Emerging Markets' Secular Investment Thesis Meets Mounting Inflation Pressures: Risk or Opportunity?

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Over the past several months, global investors have shifted their primary focus away from the lingering solvency questions afflicting the periphery of Europe to mounting inflation pressures, fueled primarily by rising energy and food commodity prices, impacting especially emerging market countries. Specifically, there is a growing cross-section of the international investor base that is questioning the accompanying risks to the secular investment thesis for emerging markets. Arguably, such concerns are evidenced most eloquently in the sudden shift in global asset allocators' sentiment on emerging markets within a short period of weeks – as seen in the latest monthly Merrill Lynch global investor survey.

This article outlines some of the dynamics conditioning the inflation debate as regards the effects on the emerging markets medium- and long-term investment outlook. Our conclusion is that listed markets, especially equities, discount a majority of the risks associated with mounting inflation pressures. It follows from this conclusion that the current juncture represents an attractive opportunity for global asset allocators to raise exposure to the asset class for multiple reasons: attractive relative valuations, superior and highly visible earnings growth outlook, and under-owned status.

Recent Inflation Dynamics and Potential Macro and Market Implications

The acceleration of headline inflation throughout the emerging markets world these past two quarters is cause for concern on four principal grounds (Table 1). First, one of the key drivers behind the recent inflation acceleration, the spike in agriculture commodity prices, shows few signs of abating (Figure 1). Second, the acceleration of headline inflation comes at a time when traditional indicators of slack (output gap) are small. Third, the spike in inflation pressures comes at a time when monetary policy conditions have been lax throughout much of the emerging markets (Table 1). Fourth, the current high inflation episode arguably represents the most significant test for emerging market countries' central banks that have embraced inflation targeting rules over the past ten to fifteen years.

Table 1. Inflation and Interest Rates in Selected Emerging Market Countries

Countries	Headline Inflation YoY %	Change in M1 YoY %	Nominal Policy Rate %
Brazil	5.91	11.95	11.25
China	4.60	13.60	6.06
India	9.47	13.60	6.50
Korea	4.10	12.90	2.75
Malaysia	2.20	11.68	2.75
Mexico	4.40	13.50	4.50
Russia	9.60	25.45	3.00
Taiwan	1.25	8.99	1.625
Thailand	3.03	10.89	2.25
South Africa	3.70	6.96	5.50
Turkey	4.90	18.81	6.25

Source: Bloomberg

By Carlos Asilis, Ph.D., with assistance from Darshan Bhatt, CFA

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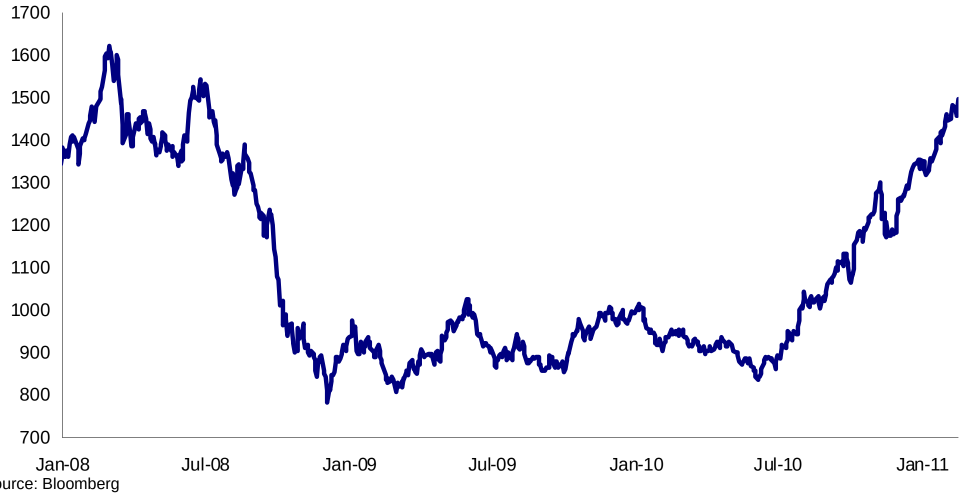
Figure 1. Rogers Agriculture Total Return Index

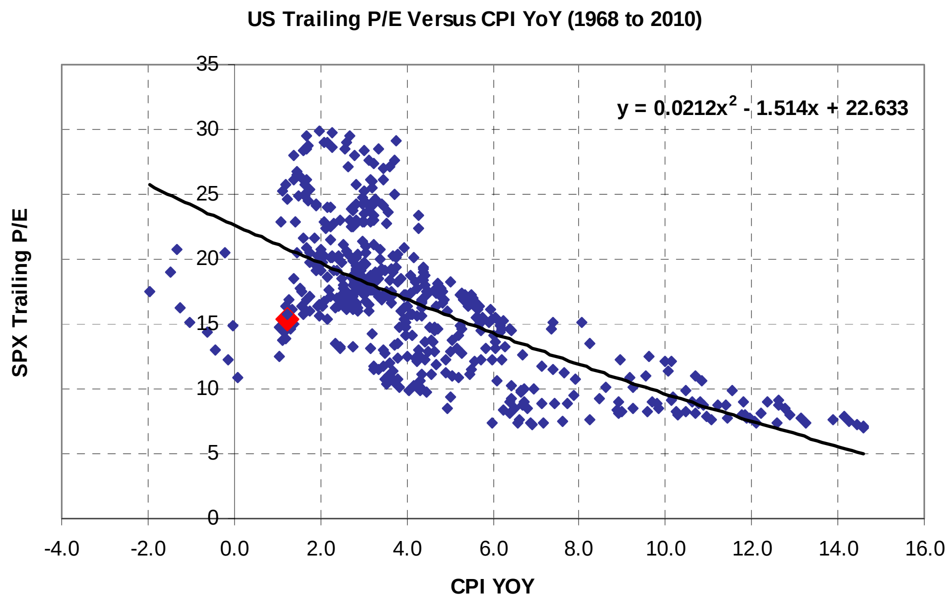


Source: Bloomberg

From a market perspective, the current inflation acceleration period is of material importance owing to two principal considerations:

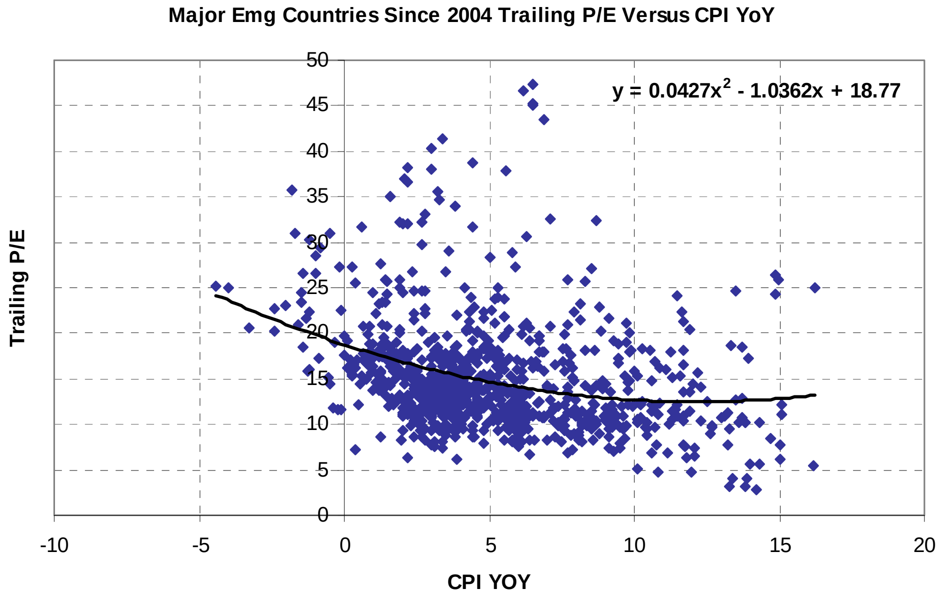
- First, historical market relationships offer a distinct inverse relationship between equity valuation multiples and inflation rate levels (Figure 2), so that a sustained rise in the inflation rate correlates with a compression in equity earnings multiples, one of the main drivers of equities' total return performance.
- Second, historical economic relationships offer a clear inverse relationship between high inflation and economic growth rates, through the erosion of household incomes' purchasing power brought about by high inflation and also through the economic deceleration brought about by tightening monetary policy conditions, the traditional policy response to mounting inflation pressures. Moreover, economic growth responds adversely to a pick-up in the rate of inflation through the corresponding rise in risk premium. The latter springs from the strong historical correlation between inflation rate levels and inflation volatility – in turn, higher inflation volatility levels feed directly into higher risk premium (partly as a result of the lower efficiency of the economy's price vector to properly signal resource misallocations at the factor and output market levels).

Figure 2-A. High Inflation Correlates With Compression in Equity Valuation Multiples : USA



Source: Bloomberg

Figure 2-B. High Inflation Correlates With Compression in Equity Valuation Multiples: Emerging Markets



Source: Bloomberg

The above considerations raise several important questions for global investors in their asset allocation decisions vis-à-vis emerging market equities, including:

How persistent is the recent high inflation episode likely to prove?

What are the likely policy responses to be chosen by central banks in forestalling an acceleration of inflation from current levels?

What are the likely macroeconomic and market implications from the current inflation scare period?

We share our stance on these issues in the balance of this report.

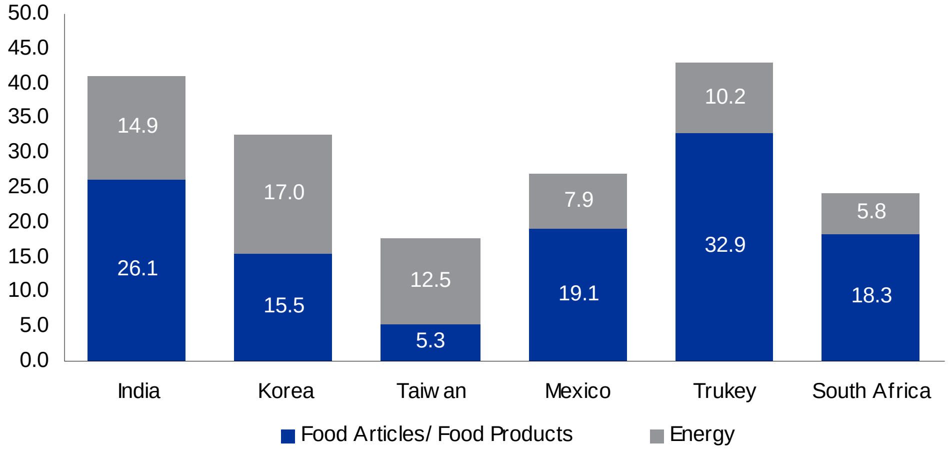
Inflation Acceleration in Emerging Markets Unlikely to Sustain Itself Beyond Middle of 2011

In our view, the recent acceleration of inflation experienced by most emerging market countries is unlikely to sustain itself beyond the middle of the year. This view reflects the traditional lead-lag relationship between agriculture commodity prices and food inflation, as well as the role of year-ago base levels in headline inflation for emerging markets, as a group.

From our perspective, it is central to recognize that inflation acceleration episodes are fueled by the combination of three dynamics: cost-push, demand-pull and inflation expectations (through acceleration of velocity of circulation of money). Examining the recent acceleration of inflation through such a prism, we characterize the current episode as being fueled primarily by cost-push dynamics, primarily linked to raw material (mostly food-related) commodities. We further characterize such cost-push conditions as transitory in nature. Of course, our view is subject to important risks discussed further below.

We attribute the current inflation acceleration period to cost-push dynamics based largely on (1) the outsized contribution of food and energy, especially food, in most of the large emerging market countries' CPI baskets (see Figure 3), and (2) the almost unprecedented supply shocks impacting world agriculture markets owing to one of the most challenging weather seasons in over 60 years for significant regions of the world – as witnessed by the traumatic effects on crops affected by droughts and floods, from Argentina to Russia and Australia (see Table 2).

Figure 3. Combined Food-Energy Percentage CPI Weightings for Selection of EM Countries (in Percentage Points)



Source: OECD, Government of India, Statistics Korea, Taiwan Directorate General and Statistics South Africa

Table 2. Recent Chronology of Salient Weather-Related Disruptions to Food Supply

Month	Event
Mar-10	Heavy rains saw much of south western and central Queensland undergo major flooding.
May-10	One of the hottest seasons on record was seen in India, where at least 250 people perished from the heat wave.
May-10	The hottest temperature ever recorded in Asia was reached in Mohenjodaro, in Pakistan, at 53.7 degrees centigrade, and nine cities in Pakistan saw temperature over 50 degrees centigrade.
Jun-10	The 2010 South China Floods killed 542 and more than 72.97 million people in 22 provinces were affected.
Jul-10	Record-breaking rainfall in Northwest Pakistan led to the worst floods since 1928, resulting in 1,400 dead and affecting thousands.
Sep-10	Hundreds of wildfires fed by relentless drought forced Brazilian authorities to place 15 of 26 states under environmental emergency.
Sep-10	Heavy rains and floods in the state of Victoria in Australia.
Oct-10	Severe flooding in Western Africa leaving 680,000 homeless and destroying 300,000 acres of crops and 81,000 livestock.
Nov-10	Flooding in Thailand resulted in the stranding of thousands of citizens.
Nov-10	Severe cold and snow storms affect parts of Europe with Trondheim, Norway's 3rd largest city, experiencing its coldest November since 1788.
Dec-10	Severe snowstorms in the USA and UK affected ground transportation and air travel for days.
Dec-10	Floods in Western Australia, caused by record-breaking rainfall that amounted to over 6,000% of monthly mean in four days.
Dec-10	A series of floods hit Queensland, Australia, on December 2010, where 3/4th of the state was declared a disaster zone.

Source: Itau Global Strategy

That supply-side conditions have exerted a central role in the escalation of food and thereby overall headline inflation in emerging market countries is illustrated by the observation that not all food staples have undergone massive price escalations these past several months – for example, the price of rice, a key food staple unaffected by similar supply disruptions, has remained stable versus levels prevailing 1, 2 and 3 years ago (Figure 4). As for most of the other food staples, the contraction of supply due to extraordinarily challenging weather conditions has resulted in the massive drawdown of world inventory levels. In turn, even by simple inspection, most of the variance in food price inflation can be explained by short-term swings in inventory conditions.

On the dynamics of ensuing periods witnessing similar supply-side-driven commodity price spikes, history teaches us that mean reversion in food prices is the rule, as opposed to the exception. Of course, supply elasticities are a lot smaller than long-term elasticities, a reason behind our earlier assessment that further near-term price escalation cannot be ruled out. In fact, we believe the potential for further short-term escalation of agriculture commodity prices has risen measurably on the back of the historic socio-political events unfolding in Egypt and the rest of the Middle East. Specifically, we believe that authoritarian regimes around the world, in response to the developments in Egypt and other Middle Eastern countries, are likely to be seeking the purchase (not only spot markets but also through forward) of large stocks of agriculture commodities. Thus, over the short term, the developments in Egypt and the Middle East should be perceived as propagation mechanisms beyond the traditional speculative push experienced in technically-driven commodity price surges.

Figure 4. Rice, a Staple Unaffected by Weather-Related Supply Disruptions, Has Not Participated in the Agriculture Commodity Price Escalation

Source:Rough Rice Futures Price, Bloomberg

Evidently, the above discussion does not render irrelevant the role of structural demand factors supporting the agriculture commodity price outlook – far from it. We include ourselves among those who pencil in sustained increases in food demand over the coming years and decades. To differ from such a view would amount to ignoring the body of evidence that has accumulated over decades, and even centuries, documenting the relationship between per-capita food consumption and household income growth as well as rising urbanization trends – with these dynamics depicting the current conditions facing some of the world's most populated places – e.g., India and China.

In the above discussion, however, it is important to acknowledge that to hold a bullish outlook on structural or secular food demand conditions is not synonymous to holding a bullish outlook on food prices relative to overall CPI inflation. This is because agriculture represents a renewable commodity group into which private capital has the ability to invest over time and thereby seek the exploitation of excess rents (beyond the competitive cost of capital). It is precisely these dynamics that account for the much larger long-term supply price elasticities as compared to the short-term when parabolic rises and declines do occur and cannot be prevented from occurring. It is especially important for investors to remind themselves of these dynamics during times of euphoria, as now, when herd behavior and opportunistic speculation at a time of supply-side-driven price spikes amplifies price behavior and thereby price expectations.

A cursory examination of implied agriculture price dynamics, embedded in commodity forward curves, is of interest as a means to ascertain the degree to which commodity markets agree with our above discussion. Table 3 summarizes the implied 12-month forward price changes (rises or declines) for some of the key commodities comprising the agriculture commodities group. Interestingly, the agriculture commodity forward markets project significant corrections in some of the fastest rising commodity groups (soybeans, corn and sugar) while projecting modest rises in rice and wheat, well within the confines of average annual trend growth rate of household disposable personal income in the world's largest emerging market countries.

Table 3. Forward Market Implied Future Price Changes for Selected Agriculture Commodities

	Spot Price	1 Yr Forward Price	1 Yr Forward Price % Change
Crude	89.29	99.10	11.0%
Wheat	822.25	909.25	10.6%
Rice	14.75	15.96	8.2%
Soybean	1,368.00	1,257.50	-8.1%
Corn	709.75	552.50	-22.2%
Sugar	31.02	19.36	-37.6%

Note: Rice Forward price is based on 6 month forward futures
Source: Bloomberg

Even if our view proves accurate and agriculture commodity price inflation abates in the coming months, the risk of pass-through from headline to core inflation remains. The risk potential is directly intertwined with the role of inflation expectations. In turn, these issues are in the realm of monetary policy and are discussed immediately below. For reference purposes, Table 4 summarizes current core and headline inflation readings for selected emerging market countries.

Table 4. Summary Headline and Core CPI Indices for Selected Emerging Market Countries

Countries	Headline Inflation YoY %	Core CPI YoY %	Note on Core Index Measure
China	4.60	2.60	China CPI Non Food YoY
Korea	4.10	2.40	Korea CPI Ex Food YoY
Mexico	4.40	3.27	
Taiwan	1.25	0.81	
Thailand	3.03	1.34	Thailand CPI non Food YoY
Turkey	4.90	3.18	

Source: Bloomberg

Role of Inflation Expectations and Central Bank Policy: Market Implications

As regards the role of inflation expectations, we believe the record is clear. Inflation expectations have not fueled the recent inflation spike. As example of such assertion's validity, we point to Table 5 which encapsulates the stability of consensus inflation expectations one year ahead (available for some countries, such as Brazil) as well as the absence of government yield curve steepening dynamics, typical of instances in which central bank's anti-inflation credentials fall into question by the markets. An additional example of the continued stability of medium-term inflation expectations during the past several months is found in the stability of intermediate and long-term nominal government bond yields for the largest emerging market countries.

The above notwithstanding, inflation expectations are highly relevant from investors' perspective, owing to the monetary policy considerations stemming from an unwinding of expectations, a lingering prospect owing to the persistent pressures on headline inflation that are likely to persist well into the year's second quarter from year-ago comparison effects as well as lagged effects from price rises in raw agriculture commodity prices. Specifically, should inflation expectations rise in response to a further sustained acceleration of headline inflation, notwithstanding that such acceleration be supply-side driven, central banks may find themselves forced to respond in tandem. They would do so by tightening monetary and credit conditions. In the process, central banks may bring about a sharp slowdown in economic and thereby earnings activity, with detrimental implications for equity and risk markets.

In our view, under a hypothetical scenario in which inflation expectations become unhinged, emerging market central banks are unlikely to tighten aggressively, owing to two important considerations: first, central banks would show a distinct displeasure with the collateral effect of an aggressive policy rate hike, for these would result in a faster acceleration of short-term foreign capital inflows, an undesirable dynamic for most emerging market central bankers; and second, emerging market economies' far larger interest rate sensitivity, compared with years ago, owing to those countries' far larger financial sector deepening levels. An additional consideration reinforcing our viewpoint is that of developing countries' governments' far greater inclination to resort to fiscal policy as a tool to contain food and energy inflation pressures. The track record is clear in this regard, including recent actions taken by governments (especially in Asia, e.g.: India, Indonesia and Taiwan) as well as actions taken during the 1997-98 Asia crisis period.

Inflation expectations play an important role in central bank policy owing to the implications of inflation expectations on wage and overall price-setting mechanisms throughout the economy. Specifically, once inflation expectations are perceived by the market to have risen over a sufficient period of time (measured in quarters, not weeks), monetary policy will have been perceived by the markets as ratifying or validating the higher inflation levels, thereby unleashing a further escalation of upside price pressures.

Central banks resist allowing such pernicious inflation mechanisms to take hold, regardless of the source for such expectations' spiraling dynamics. The central bank mantra is well entrenched globally, especially in the so-called central bank era that started in the early 1980s under Volcker's US Federal Reserve. Central banks' staunch defense of low inflation regimes is anchored in the large body of empirical evidence documenting the strong nexus between low inflation and high economic growth – with important exceptions, such as Japan's since 1990, for reasons specific to that country's demographic and highly distorted savings-investment transmission mechanism.

Table 5. Summary of Proxy Inflation Expectations for Selected Emerging Market Countries

Country	Jun-10	Sep-10	Dec-10	Current
Brazil	5.64	5.20	5.61	5.82
India	1.95	1.12	0.57	0.32
China	0.75	0.76	0.34	0.62
Russia	2.19	2.10	2.32	2.39
Taiwan	0.75	0.62	0.38	0.26
Korea	1.35	0.90	1.19	1.00
Mexico	1.37	0.77	1.53	1.82
South Africa	NA	0.26	0.57	0.66

Source: Bloomberg
Note: The data for Brazil is a survey of 12 month forward inflation expectations, the data for India, China, Russia, Korea and Mexico is the spread between 5 year and 1 year nominal government yields, the data for Taiwan is the spread between 5 year and 2 year nominal government yields and the data for South Africa is the spread between 5 year and 3 year nominal government yields.

Current Bout of Inflation Concerns: A Golden Opportunity to Raise EM Allocations Based on Valuations, Growth Potential, Under-Ownership Status, and Disinflationary Effects From Globalization

From our perspective, the current bout of inflation in emerging market countries represents a golden opportunity for global asset allocators to raise exposure to the asset class. Our view is based on the following observations:

Attractive relative valuations: The four month long period of relative underperformance between emerging and developed equity markets has resulted in the cheapening of emerging markets' relative valuations to the low end of a multi-year range (Figure 5).

Figure 5. MSCI Emerging Markets Trailing P/E Ratio Relative to S&P 500 (Times)

Source: Bloomberg

Superior earnings growth outlook: By all accounts, including official ones, such as estimates published by the International Monetary Fund, emerging market countries' medium- and long-term economic growth potential lies in the vicinity of 3 to 4 times larger than developed countries' potential. If we were to apply standard GDP to earnings growth multipliers to these economic growth differentials and also account for emerging market currencies' strong revaluation outlook versus developed country peers, the implications for official and also private sector economic growth estimates on earnings growth would correspond to differentials in the vicinity of 5 to 6 times, at least.

EM's stand-alone earnings multiple compression potential appears rather limited from current levels: Our discussion above reflects our expectation of continued upward rise in headline inflation through much of this year's second quarter. Figure 2B illustrates the market's discounting of a further rise in headline inflation by 100 basis points. Specifically, emerging markets' current 14 times trailing P/E multiple is consistent with a further run-up in headline inflation of at least 100 basis points.

Emerging market equities' under-owned status: Emerging market equities, even before the recent period of relative underperformance of developed market peers, represented a heavily underweight asset class on account of (a) the difference between emerging markets' vastly stronger economic and earnings growth fundamentals, (b) attractive relative valuations, (c) potential for secular currency strength versus developed country peers and (d) the disparity between emerging markets' vastly smaller share of global stock market capitalization when compared with emerging market countries' current share of global GDP, especially on a purchasing power basis. The recent period of underperformance has pushed the asset class' under-owned status to even more significant levels, as witnessed by the latest release of Merrill Lynch's monthly global investor survey.

Secular disinflationary dynamics stemming from globalization and liberalization trends: From a longer-term perspective, it is important to remember the distinctly powerful disinflationary dynamics permeating most emerging market countries on account of (a) globalization, which allows for the more effective capture of gains from trade versus prior periods of trade protectionism and limited communication; (b) liberalization, through the presence of deeper competitive interactions resulting from economic liberalization and deregulation taking place throughout most emerging market countries.

Disinflationary dynamics stemming from services' heavier weighting in overall CPI indices as urbanization trends take hold and countries' prosperity levels rise: Finally, it is also important to acknowledge that as countries become more prosperous, a declining share of household budgets are allocated to the consumption of goods, and so a larger share is allocated to service areas. Services are largely non-tradable in nature and thereby far more responsive to monetary policy actions. Moreover, service inflation is far more predictable and stable than goods inflation. This is partly the result of the statistical observation that goods inflation is far more responsive to productivity growth and also far more volatile, as goods inflation includes energy and food.

Carlos Asilis is currently the CIO at Glovista Investments. In the past, he has served as Global Strategist on the proprietary trading desks at Banco Santander (Madrid) and on the emerging markets fixed income proprietary trading desk of CSFB (New York), and he was Global Macro Trading Strategist at VegaPlus (New York). Carlos has also served as Chief US and Chief Emerging Markets Equity Strategist at JPMorgan Chase (New York) and Chief Emerging Markets FX Strategist at Merrill Lynch (New York). Prior to his tenure in the financial industry, Carlos served in the early 1990s at the International Monetary Fund (Washington DC) as the principal research economist with economic surveillance responsibilities for the Russian Federation and China, among other responsibilities. Prior to his tenure at the Fund, Carlos taught pure and applied economics at Georgetown, the University of Chicago and the Stockholm School of Economics. He holds Ph.D. and M.A. degrees in Economics from the University of Chicago and a BSE (honors) degree in Finance and Economics from the Wharton School. He sits on several external global investment committees, including that of ICICI Bank (Mumbai, India).

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