

## Strategy Matters

Issue 2008 – 12

### Stagflation?

**Global inflation has increased markedly in the past year due to sharp rises in energy and food prices. As this has played out against a backdrop of slowing demand, it has hindered central banks from loosening policy to accommodate the weaker growth. Trends in unit labour cost and core inflation suggest that we may be nearing an end to this ‘stagflationary’ environment.**

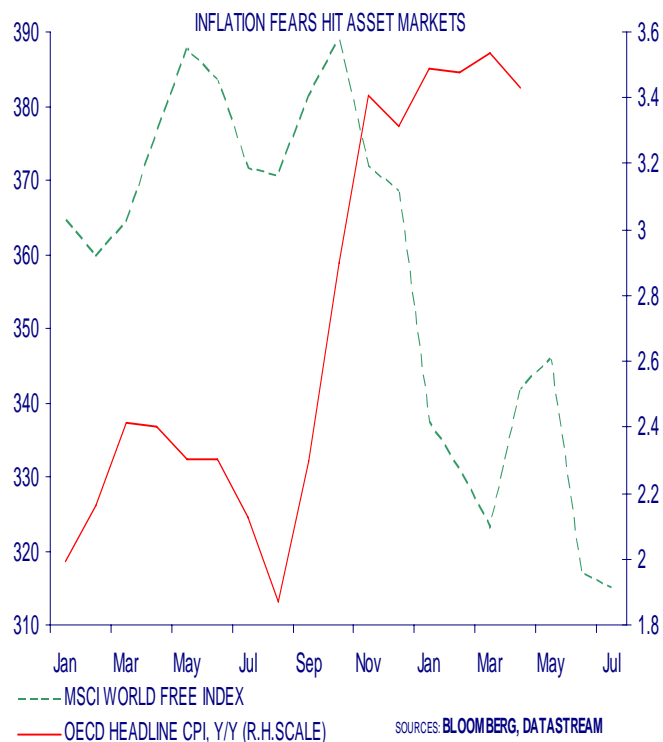
#### Inflation blow-out...

The EU, UK and US have seen their headline inflation rates move considerably above target in recent months. Australia and New Zealand are having trouble reining in inflation and even Canada, which has experienced a benign downward adjustment in its inflation due to the strong currency, experienced an upside surprise in its most recent CPI print. Emerging economies are also battling sharp increases in their rates of inflation. In sum, inflation has become a global problem.

But what type of problem is it? Has the rise in headline inflation unmoored long term inflation expectations? If so, has the rise in long term expectations caused an increase in wage settlements, and in turn core inflation? These are some of the questions we endeavour to address in this note.

#### ...it's all headline(s)

There is no mistaking the sharp rise in global headline inflation rates. OECD headline inflation has moved from a cyclical bottom of 1.7% year-on-year (y/y) in October, 2006 to 3.4% in April of this year. At the same time, the gap between headline and core inflation, which excludes food and energy, hit its second highest level in thirty four years (Chart 3). The 25% and 30% rises in

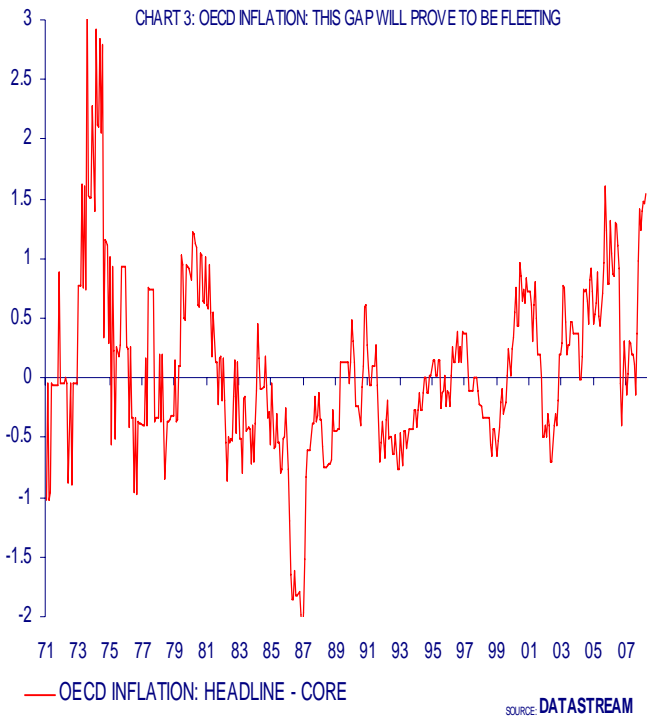


food and oil prices, respectively, have led to the blow-out in global headline inflation. And whilst the duration of the gap between the headline and core rates has surprised central banks, it is nevertheless transitory in nature.

recent weeks including China, India, Indonesia, Korea and Malaysia.

These reactions are strong signals of a shift from price-inelastic to price-elastic demand behaviour. Thus, given the fact that oil demand growth has fallen relative to that of supply in five out of the last seven months for which data is available, it is difficult to explain the continued rise in the price of oil on any fundamental basis.

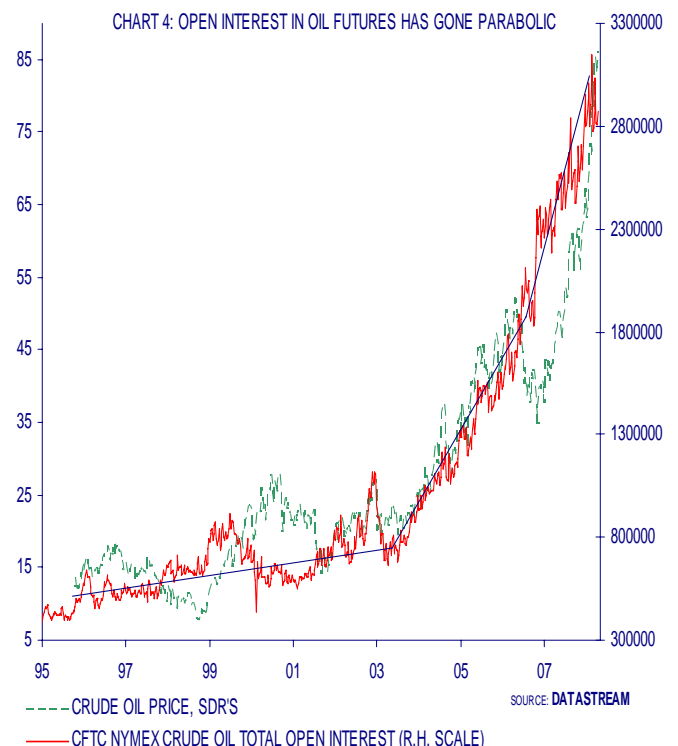
Reconciling the rise in open long interest in the futures market versus fundamental dynamics is equally difficult. It is well known that non-commercial contracts fixed on the CFTC do not include *all* non-commercial (speculative) interest as many of the world's largest investment banks are designated as hedgers. Thus, data on non-commercial open interest gives a 'picture' of how speculators could be positioning, but not the full magnitude of their positions. What is relevant is that in the 1995-2003 period, CFTC total open interest on oil rose approximately 70% - a stark contrast to the 284% increase since 2003 (Chart 4).



### Oil

The price of West Texas Intermediate oil is up 30% so far this year. It is difficult to imagine that during the same period marginal demand has increased enough versus marginal supply to justify the price increase. In fact, according to OECD data, average global marginal oil demand grew by around 0.2% to supply growth of about 0.03% through the year to February. The relatively stronger demand requires a higher price to act as a release valve and there are growing signs that the feedback loop into softer demand is working:

- Global oil demand fell 1.1% y/y in February
- More timely data on US petrol purchases shows they fell 3.8% y/y in the year to July 11<sup>th</sup>
- US vehicle miles driven have fallen for the first time since the early 1980's
- Various emerging economies have either spoken about removing or have removed subsidies on energy prices in



To our knowledge 2003 did not mark a material change in hedgers' use of the futures market in their daily business operations to prompt the

large increase in futures activity seen since then. What did occur was a shift in the investment community's perception of its 'investable universe' of assets to include commodities and other alternative assets which prompted a large 'paper' inflow into investable instruments related to them. Thus, whilst it is difficult to separate the price effect of paper from that of real demand for oil, this much is true: as real demand continues to erode, the basis for holding oil as an investment asset will too come into question meaning that there could be a large amount of sellers in the oil, and in general, commodities futures markets in the very near future.

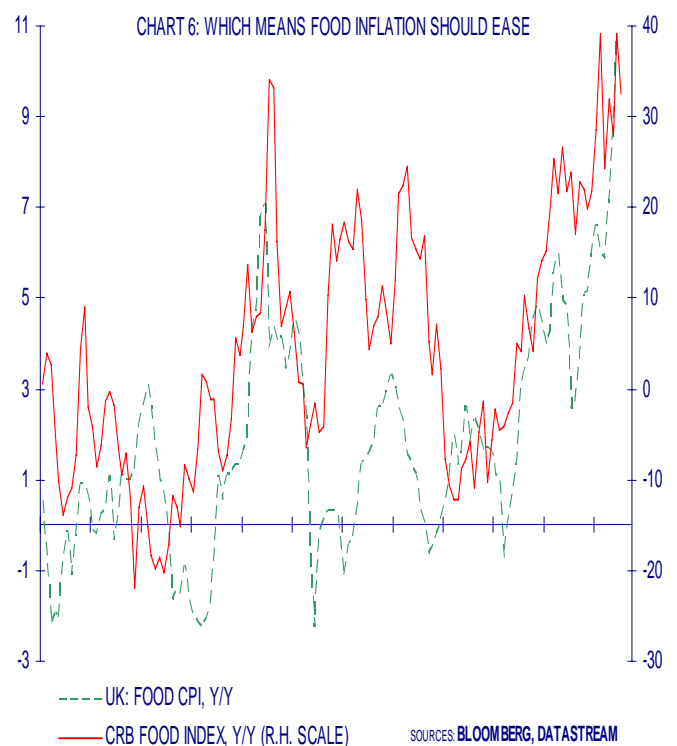
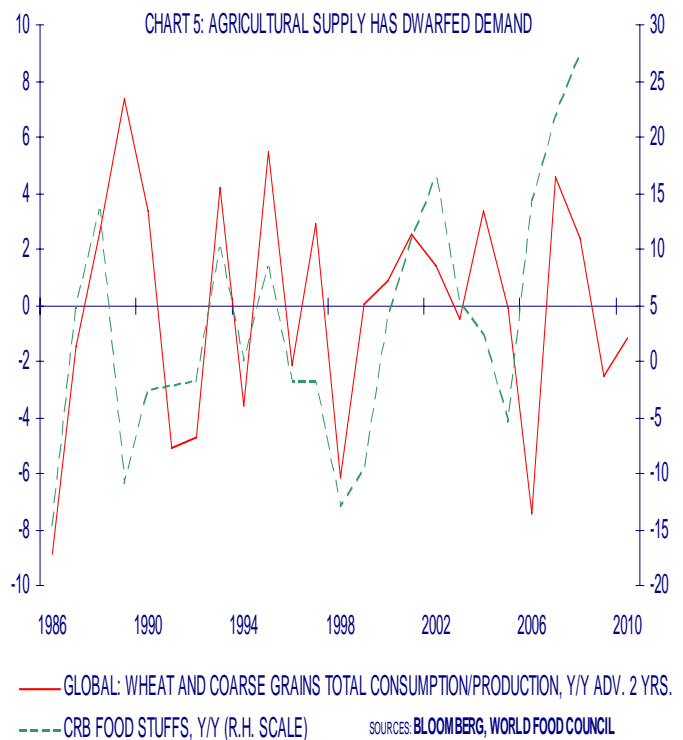
### Food

The scale of food inflation has also caught global central banks flat-footed over the previous year. According to the CRB's Foodstuffs index, food prices are up 30% year-to-date. There are both cyclical and structural factors for the unrelenting rise in food prices, some of which have recently become headwinds.

On the structural side, emerging market consumers have become wealthier in recent decades and as a result have demanded higher quality foods, especially meats. There is a fairly tight positive correlation between per-capita income and protein consumed which means that, in the long run, this trend looks set to continue. However, in the long run, supply is flexible which also means that producers react to higher prices meaning that the types of price increases seen so far this year, are unsustainable. Furthermore, the long run emerging market demand story has also hit a snag as the sharp rise in oil and food prices has crunched real income growth and forced consumers to substitute back to cheaper food products. The EM demand boom has, in essence, become self-limiting.

The cyclical picture has also become less positive. Supply is fixed in the short run due to the inability of agricultural producers to increase acreage. Thus, when unpredictable weather adversely affects growing conditions, a higher price immediately acts as the release valve. Though 2007 saw a number of key producing

regions affected by adverse weather conditions, producers were nonetheless able to supply more than enough wheat and coarse grains to meet demand (Chart 5). As a result, the price of wheat has fallen 35% since mid March and we expect the CRB Foodstuffs index to ease in line with past relationships (Chart 5) and hence bring down global food inflation (Chart 6).



### Core inflation: pass-through or just pass?

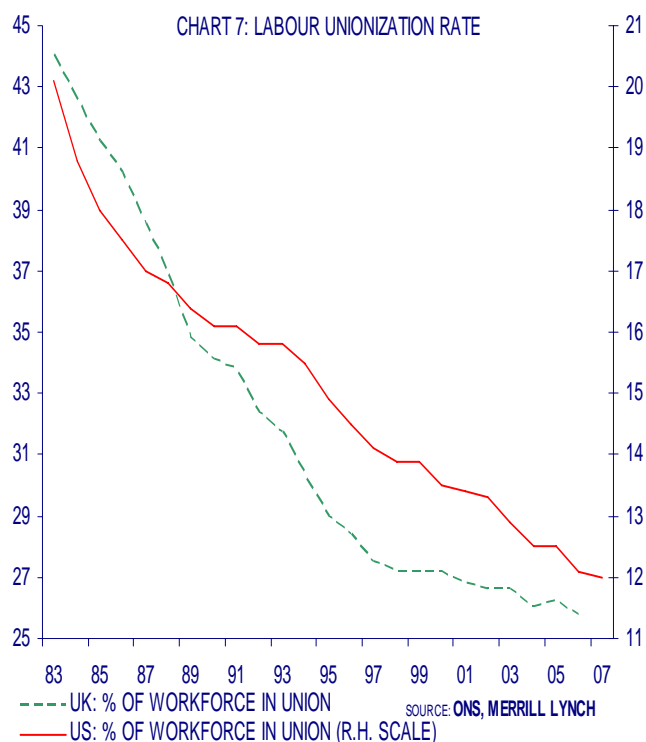
Based on our outlook that food and oil prices should correct over the next three months, we believe that headline inflation could come down rather sharply in three to six months as well. Global central banks likely have a similar view; however, the problem they face in the intervening time period is one of pass-through.

The reason central banks are reluctant to cut interest rates, and the ECB actually hiked its rate, is a universal concern amongst them that this temporary spike in food and energy has the potential to result in higher wage settlements for workers. This idea is predicated upon the assumption that the labour market's expectation of rising inflation is at some stage translated into the granting of higher wages by their employers. However, a review of wage and unit labour cost data shows little to no evidence of developed markets' corporate sector having awarded wage increases in a slowing growth environment in more than a decade. On the contrary, in times of economic weakness, the corporate sector has shown a greater propensity toward cost control and efficiency gains, even in countries where the labour market is thought of as inflexible such as in EMU. Thus, if a wage-price spiral were to occur, it would signal a fundamental change in the corporate sector's approach to labour compensation - effectively an unwinding of the structural shift toward de-unionization which began in the early 1980's. We have found no evidence of this occurring.

#### *The structural backdrop remains intact*

Since the early 1980's a combination of tough government policy and the rise of Asian manufacturing has led to a precipitous fall in the rate of labour unionization in the developed world (Chart 7). As a direct result, the prevalence of wage-price spirals also decreased as the percentage of workers with cost-of-living-adjustments, or wage indexation, in their contracts decreased. According to the data which is available (Chart 7), there has not been a reversal in this trend. Manufacturing and basic service jobs continue to move from the developed to the developing world as the latter's general price level remains some 70% below that of the former in US dollar terms. As long as any such disparity persists, the pressure of

competitive forces on the developed world's corporate sector will force it to continue to drive down costs. As labour is the largest part of most companies' cost structure, this remains the area in which the most cost advantage can be gained.



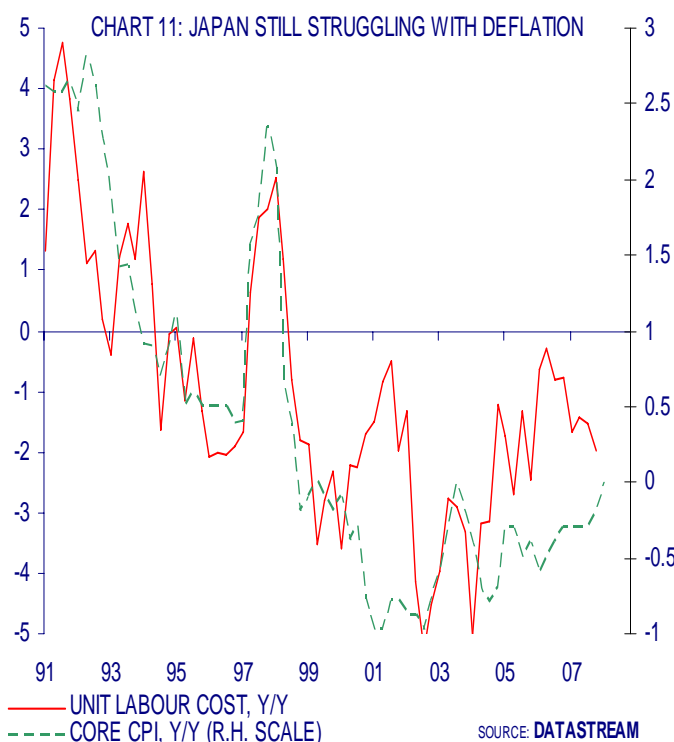
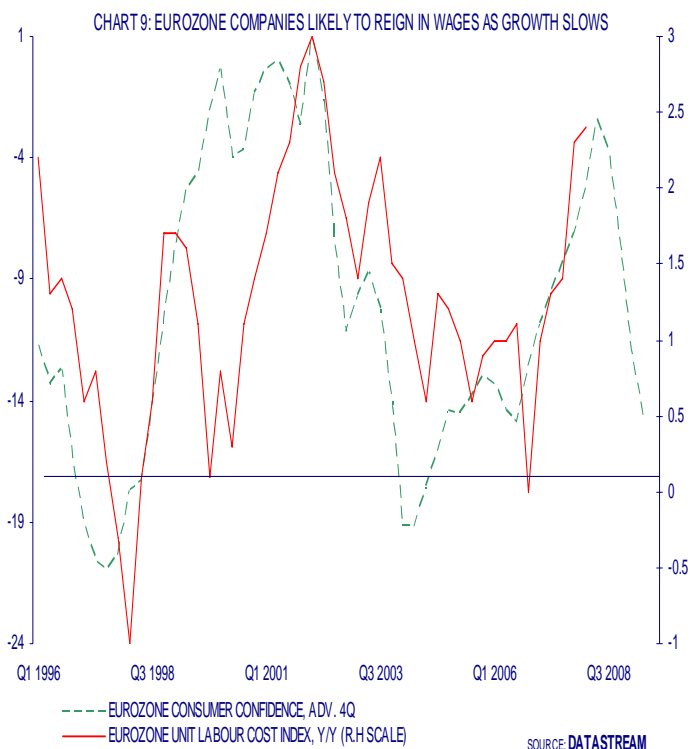
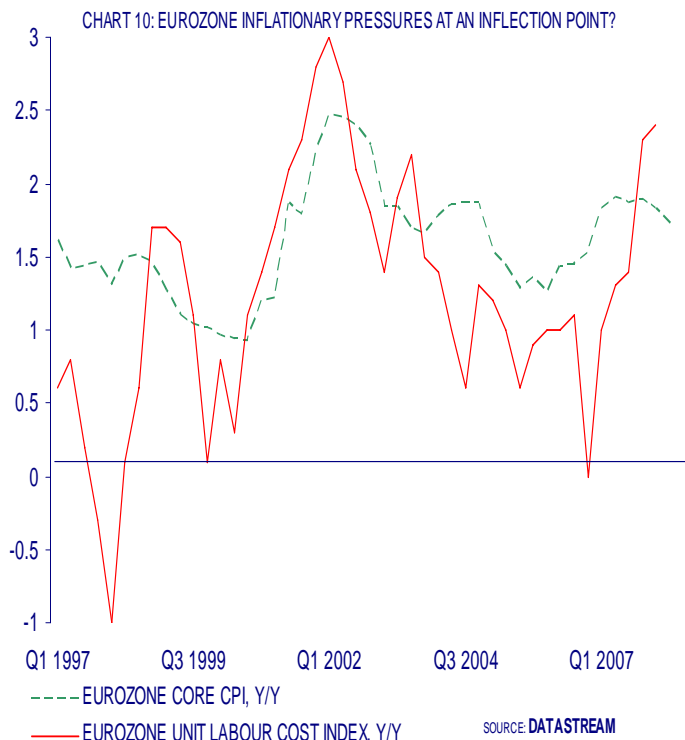
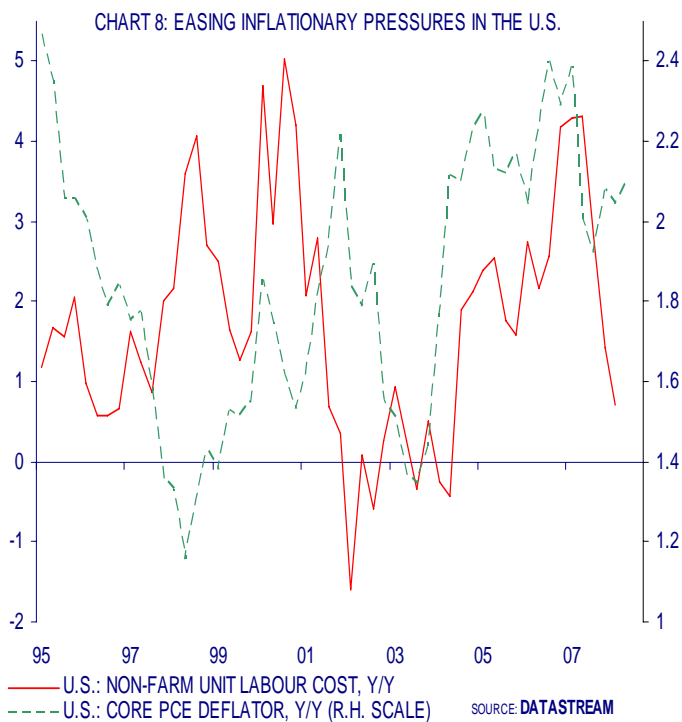
#### *Efficiency in action*

As the global growth slowdown continues to spread, there are signs that the corporate sector has, thus far, worked to boost productivity and, where possible, decrease its wage bill. Having the most flexible labour market in the developed world means that these efforts have already come through in US data. The US corporate sector has managed to push down unit labour cost (ULC) inflation from a cyclical peak of 4.3% y/y in Q2 of 2007 to less than 1% just nine months later. Lower ULC inflation eases inflationary pressures in the overall economy (Chart 8) and given the continued deterioration in the labour market and falling wage growth, this trend has likely continued into the second quarter.

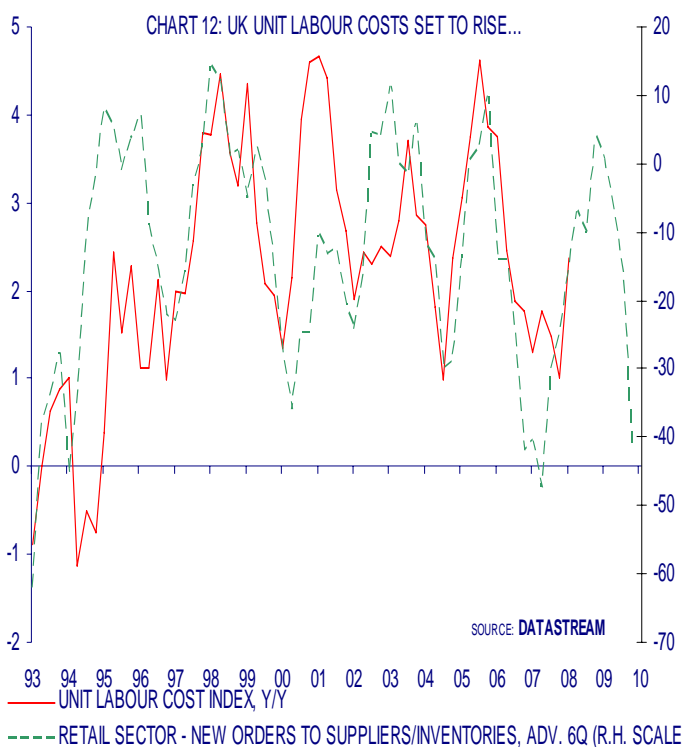
The Eurozone has seen wages pick up, as growth has slowed slightly which has pushed ULC growth from 1% y/y in Q2 of 2007 to 2.4% in the first quarter of this year – a trend which continues to concern the ECB. But despite

having a relatively less flexible labour market than that of the US, history suggests that the Eurozone's corporate sector has had reasonable success in boosting productivity and driving down ULC growth in times of economic weakness. Chart 9 suggests that Eurozone ULC growth is near a cyclical peak which should also mean that core inflation is as well (Chart 10).

Japan continues to struggle with deflation. Though its headline inflation rate has been positive for eight consecutive months, there is no core inflation and ULC's, having recently rolled over, continue to deflate at a rate of 2% y/y (Chart 11). Given the global demand outlook it will be some time before Japan is able to generate any cyclical inflation.



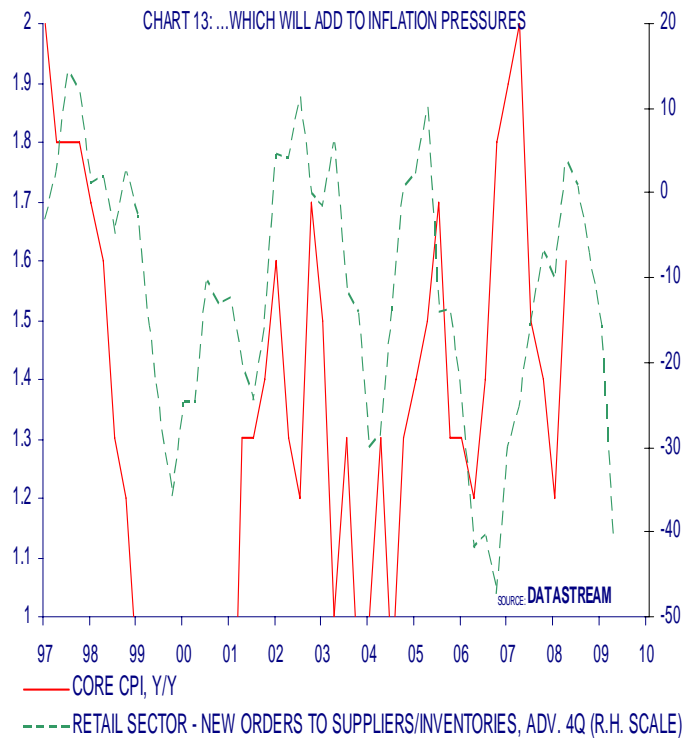
The UK finds itself in a somewhat more precarious position as average earnings growth remains stable at a time when economic growth is only beginning to slow risking a period of higher ULC inflation in the ensuing quarters (Chart 12). This means that the UK faces much greater uncertainty as to the eventual peak in its headline inflation rate than do the aforementioned regions - something The Bank of England (BOE) is acutely aware of. Thus, the BOE is likely to continue to emphasize their mandate of price stability to foster long term growth as core inflation approaches its peak in the 1.7-2.0% range (Chart 13). Only when softer energy and food inflation becomes more entrenched – which could well be in the next 1-3 months based on our views presented above – will the BOE be able to ease its stance.



### Conclusions

Headline inflation is very close to peaking in the US, EMU and Japan whilst it could still track higher in the UK, as rising unit labour costs push core inflation up, before its eventual peak. The run-up in food inflation is long in the tooth as agricultural supply exceeded demand in 2007 and looks to be on a similar track this year. Despite there being a strong argument for a higher long-term oil price, the recent run-up has become self limiting. Going forward, oil should

stabilize and possibly correct further as the global growth slowdown spreads. Unit labour cost trends remain benign and should come under further cyclical pressure. All these factors should allow inflation pressures to ease later this year and in 2009.



**Adrian Pankiw**  
 Economic Analyst  
 Henderson Global Investors

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