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EUROPEAN MARKET COMMENTARY

EUROPEAN CONSUMER PRICES SET TO RISE?

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European Consumer Prices Set to Rise?

"Inflation … means increasing the quantity of money and bank notes in circulation and the quantity of bank deposits subject to check. But people today use the term 'inflation' to refer to the phenomenon that is an inevitable consequence of inflation, that is the tendency of all prices and wage rates to rise. The result of this deplorable confusion is that there is no term left to signify the cause of this rise in prices and wages. There is no longer any word available to signify the phenomenon that has been, up to now, called inflation. It follows that nobody cares about inflation in the traditional sense of the term."—Ludwig von Mises, *Inflation—An Unworkable Fiscal Policy*, 1951.

"The notion that the risk of inflation is dead is still so widely held and so thoroughly priced into treasury markets that we think the smart bet is that inflation will be significantly higher than expected. But, the picture is murky at best."—Greg Jensen, Bridgewater Associates, *Bridgewater Daily Observations*, May 15, 2008.

"So far, although there has been plenty of talk from policy-makers about inflation, there has been little or no action."—Tim Bond, Barclays Capital, *Global Speculations: Getting Nasty*, May 16, 2008.

As John Kenneth Galbraith noted roughly 50 years ago, the problem with conventional wisdom is that it is often wrong.[1] (We would add that an additional problem lies in defining exactly how one should identify the conventional wisdom!) At the moment, most people seem to believe the European Central Bank (ECB) has played hawk to the Federal Reserve's dove during the ongoing credit crisis, and that Eurozone prices will therefore remain better anchored than those elsewhere (particularly in the United States). However, while it is true that the ECB has held policy rates stable in recent months as the Fed has aggressively cut rates, a closer look at the banks' actions shows the ECB has actually pumped money into the system faster than the Fed, even as ECB officials have continued to "talk tough" on inflation. Thus, investors should be cognizant of the possibility that Eurozone consumer prices could continue to rise, possibly at an accelerating rate. Such an outcome would provide a headwind to still-expensive equity markets,[2] as well as put pressure on the ECB to raise policy rates. The net effect on the euro—relative to other currencies—is harder to gauge. While higher rates (in real terms) would be expected to attract foreign investors, rising consumer prices and a weakening economy are generally not a recipe for currency appreciation.

Our analysis focuses on the Eurozone; however, it is worth noting that despite broad media coverage and increasing angst over rising prices, particularly those for food and energy, bond markets worldwide continue to trade as if rising consumer prices are a remnant of some bygone era (Table A). While investors may simply believe the deflationary forces of the ongoing debt unwind will overwhelm government efforts to "reflate" the economy,[3] in our opinion the more likely explanation is that nearly three decades of disinflation

[1] John Kenneth Galbraith, *The Affluent Society*, 1958.
[2] For more details on European valuations, please see our April 2008 Market Commentary *European Equities Are Not Cheap*.
[3] For more on reflation, please see our April 2008 Market Commentary *The Fed's Reflationary Effort: Will it Work and What Are the Risks?*

have convinced most investors that a severe inflationary outbreak—i.e., an extended period of sharply rising prices—is highly unlikely.[4]

Which Inflation Do You Mean?

Recent central bank activities have clearly been inflationary in the classical sense (i.e., expansion of the money supply);[5] however, it matters a great deal whether the inflation manifests itself primarily through rising consumer prices or rising asset prices. While rising consumer prices would, as noted above, prove a headwind for equities and bonds, rising asset prices would have the opposite effect, but *only in the short term*. Indeed, given the uncleared debris[6] from the two most recent bubbles (tech stocks in the late 1990s and real estate over the past several years), rising consumer prices would likely represent the "least bad" outcome for investors over the long term, as rising asset prices would simply exacerbate long-standing global imbalances that *must* be resolved in order to lay the groundwork for sustainable economic expansion.[7]

It is also possible, of course, that the ongoing global debt unwind will stymie central banks' reflationary efforts. In other words, debt repayment/default could extinguish money and credit faster than central banks can create it, in which case we would expect consumer *and* asset prices to fall. While there are important differences between today's environment and that of Japan over the past 15 years or so, Japan's experience nevertheless provides an example of how rock-bottom interest rates and economic "pump-priming" by the government may be ineffective not only in boosting economic growth, but also in causing prices to rise.

Talking the Talk

As alluded to earlier, while the ECB has been lauded (or criticized) for its "tough" stance on policy rates, it has simultaneously ballooned its balance sheet to a far greater degree than the "easy" Fed (Table B). In the words of James Grant (editor of *Grant's Interest Rate Observer*), the ECB has recently "engaged in one of the greatest money-printing exercises of all time." Indeed, while we certainly consider the Fed's interest rate cuts to be inflationary (as central banks generally lower rates by purchasing debt with fresh currency), balance sheet expansion is simply another method to a similar result, as both introduce new currency into the system.

Further, the ECB has recently expressed "concern" over the quality of assets it has accepted in exchange for government debt, while some have questioned whether this bad debt will ever be returned to its

[4] It could also be argued that the low implied inflation rates in inflation-indexed bond markets are a reflection of investors' mistrust of official inflation statistics. In other words, if investors believe consumer *prices* are rising faster than price *indices*, they will be less inclined to hedge this risk through instruments that pay out based on index values. However, this does not explain the low rates currently available on nominal government bonds.

[5] Milton Friedman, for example, famously decreed that "inflation is always and everywhere a monetary phenomenon."

[6] Defined essentially as a large volume of bad debts.

[7] For our most recent thoughts on this topic, please see our April 2008 Market Commentary *The Eye of the Storm.*

original owners. According to the *Financial Times*, "Investment bankers who work in securitization say that their main business is structuring bonds that are eligible for ECB liquidity operations. Some analysts have concerns about whether the bonds being created will ever be saleable if markets recover." Indeed, European M2 and M3 have both risen steadily in recent months (Table C), with much of the growth driven by an increase in the "debt securities" category. In simple terms, the ECB has traded newly printed currency for debt where repayment is far from certain. While the Fed has engaged in similar behavior, it has for the most part exchanged existing Treasury holdings (rather than fresh cash), thus "sterilizing" at least some of the impact.[8]

Finally, we would be remiss in not mentioning the global inflationary pressures that have been building in recent months, particularly in emerging markets (Table D). As Tim Bond of Barclays Capital recently noted, "It is fair to say, in the context of both the raw material inflation and the imported manufactured goods price inflation, that globalization is now an unalloyed force for rising inflation, not disinflation." Indeed, according to Barclays, import prices for the Eurozone are now running at a 6.5% clip year-over-year *even when food and fuel prices are excluded.*

Conclusion

While the conventional wisdom is that the ECB has been hawkish in recent months, it has in fact been exceedingly accommodative, and in so doing laid the groundwork for prices to rise. Further, the globalization that had until recently held inflation in check has turned into an inflationary tailwind, with prices rising sharply in most emerging countries. Thus, we expect Eurozone consumer prices will rise at a faster-than-expected rate over the next several years, with deleterious effects on equity *and* bond prices, neither of which are priced for such an eventuality.

However, there are some significant caveats to this view. First, our expectations about continued inflation (i.e., expansion of money and credit) are largely based on the actions and stated intentions of central banks (including the ECB) to do "whatever it takes" to keep the global economy afloat. In the ECB's case, while top officials have *sounded* much tougher on inflation than their peers, they have *acted* in a manner that belies such statements. In short, while we believe recent actions provide a good roadmap to future intentions, we cannot know with any sense of certainty what central bankers will choose to do in the future. Second, even assuming central banks do continue to create inflation, there is no guarantee it will manifest itself through rising consumer prices. (As noted earlier, rising asset prices would simply serve to exacerbate current global imbalances, and under such circumstances we would certainly not recommend chasing prices

[8] Basically, by holding its balance sheet constant the Fed does not increase the volume of money (or credit) in circulation. However, the process of trading good assets for bad ones is inflationary on its own merits (again, *ceteris paribus*), as banks that would have otherwise had to shrink their balance sheets due to bad debt write-downs are now able to avoid such actions.

higher.) Finally, there is a non-negligible possibility that the deflationary tow of the global debt unwind will overwhelm central bank efforts.[9]

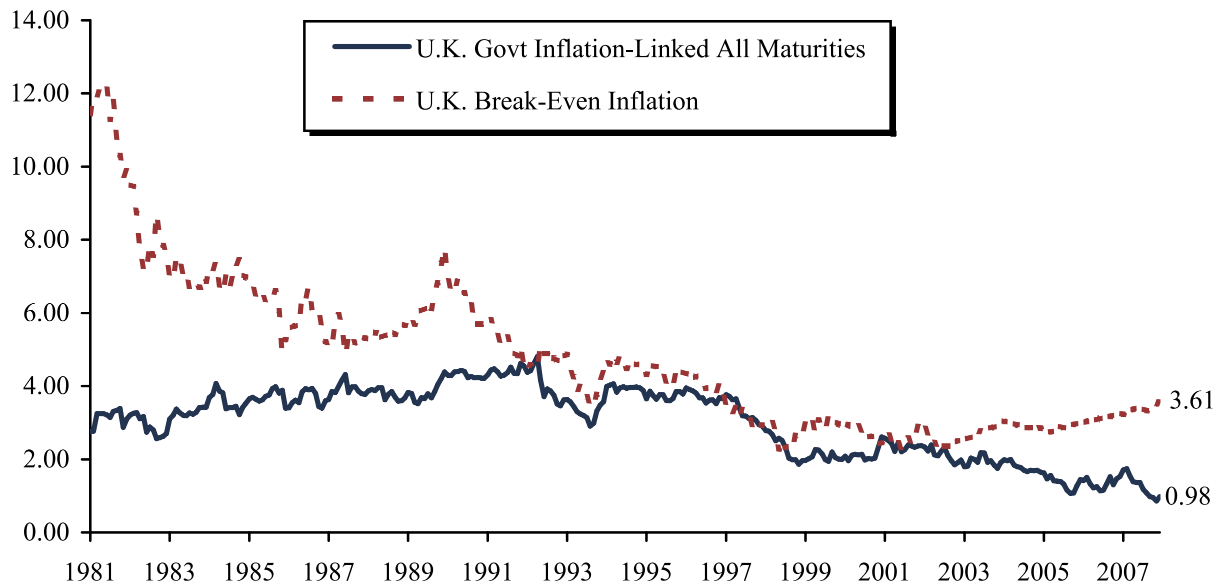
Inflation hedging, unfortunately, is an inexact science.[10] Nevertheless, investors concerned about the risk of rising prices should hold a reasonably sized basket of inflation-sensitive assets (i.e., "hard" assets such as commodities, real estate, etc.) that will offer protection and/or cash flow in a high-inflation environment, despite the fact that several of these areas look cyclically extended at the moment. (We would also note that most investors in global equities already have a modicum of inflation sensitivity through exposure to commodity stocks. The energy and materials sectors together make up roughly 20% of the MSCI World Index, and more than one-third of the MSCI Emerging Markets Index.) We acknowledge that "reasonably sized" is a bit vague. However, in sizing allocations investors must consider both the sensitivity of various investments to rising prices (also known as the inflation beta), and the availability of appropriate inflation-sensitive opportunities.

[9] There is another possibility we have not discussed—the ECB could take steps to remove money and credit from the system, which would almost certainly quash any prospective rise in prices. However, given the current proclivities of central bankers to respond to any and all economic problems by lowering rates and/or printing money, we regard this as highly unlikely, particularly in the near term.
[10] For a detailed discussion of inflation-hedging options, please see our 2004 report *Global Inflation Hedging.*

Table A

EUROPEAN REAL YIELDS AND BREAK-EVEN INFLATION

United Kingdom
31 May 1981 – 30 April 2008



Eurozone
31 December 1999 – 30 April 2008

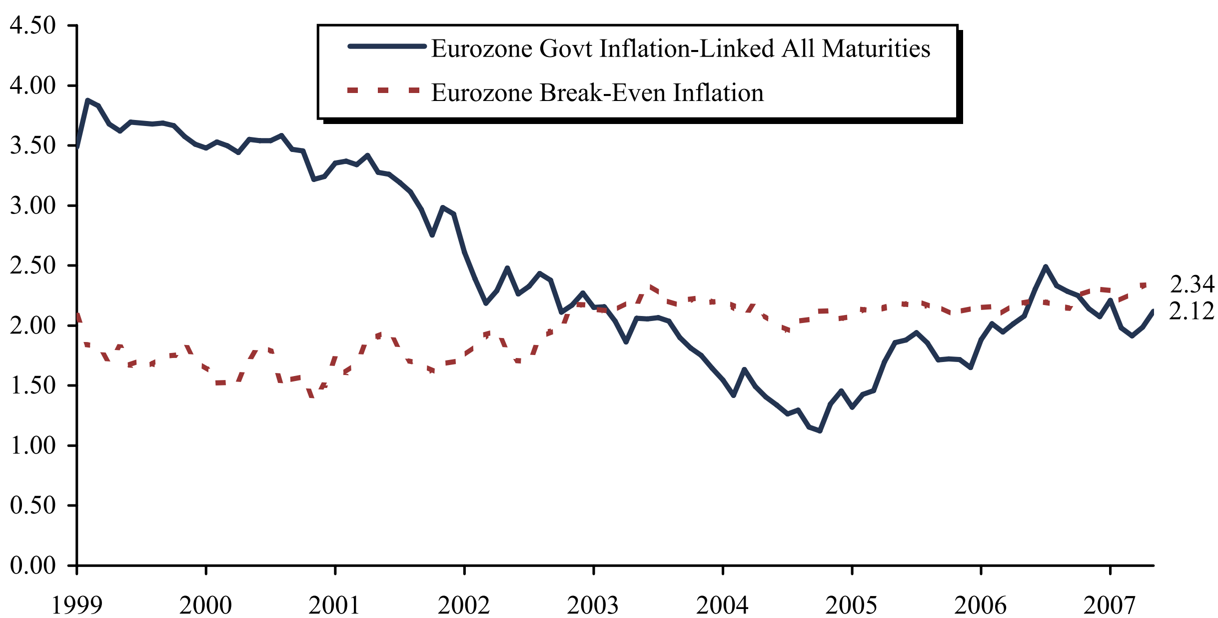
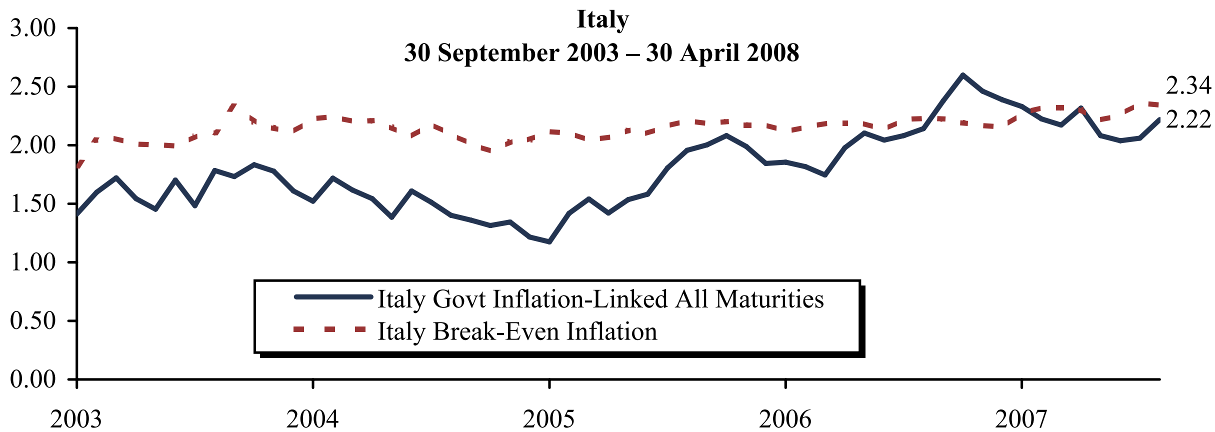
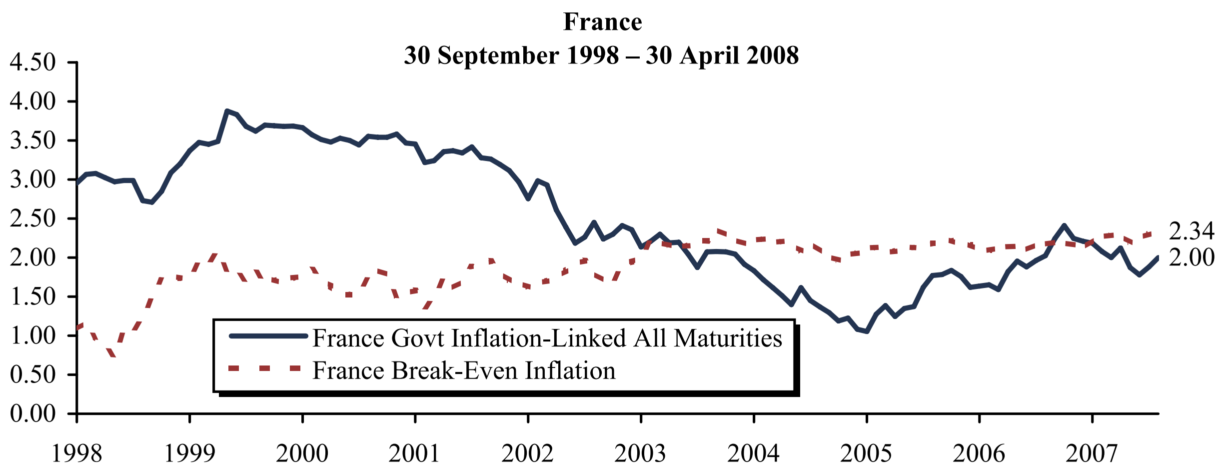
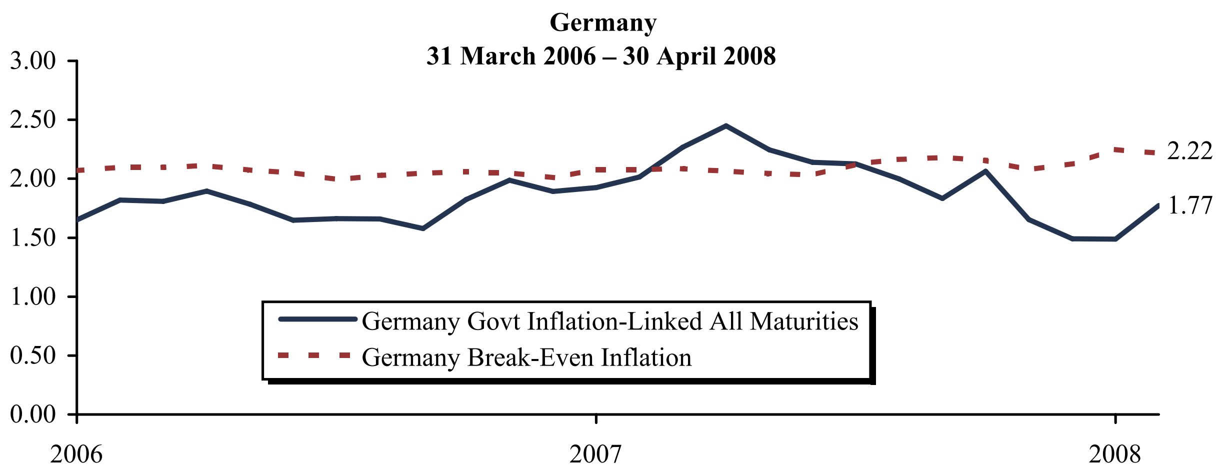


Table A (continued)

EUROPEAN REAL YIELDS AND BREAK-EVEN INFLATION







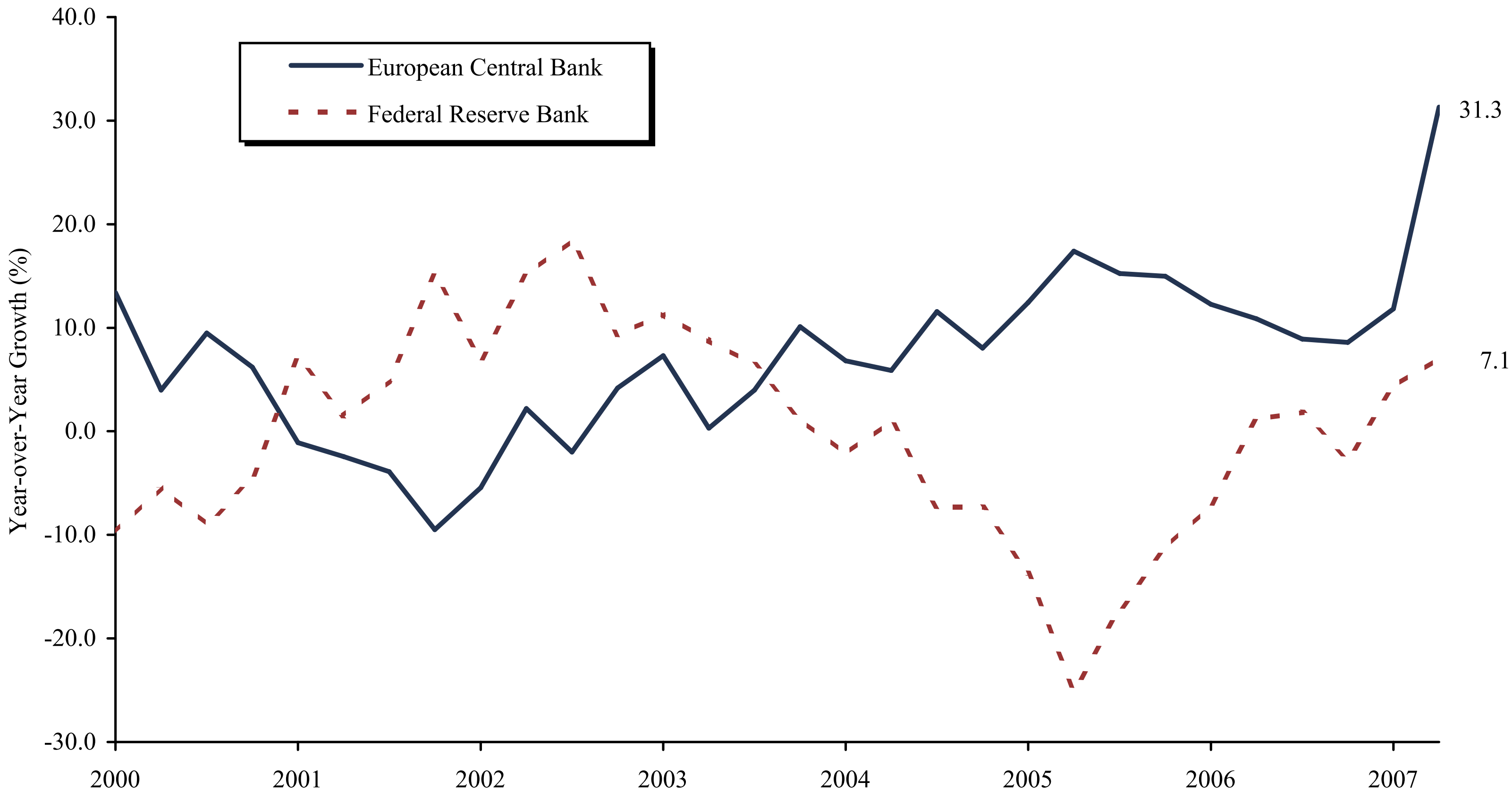
Source: Barclays Capital.

Note: Real yields and break-even inflation based on Barclays Global Inflation-Linked Bond indices.

Table B

CENTRAL BANK BALANCE SHEET GROWTH

30 September 2000 – 31 December 2007



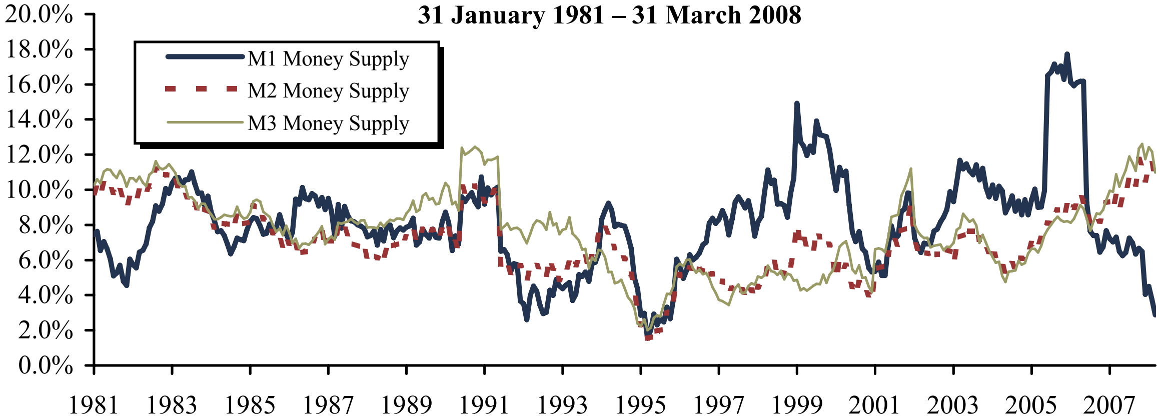
Sources: FactSet Research Systems and Thomson Datastream.

Note: All data shown are nominal and not seasonally adjusted.

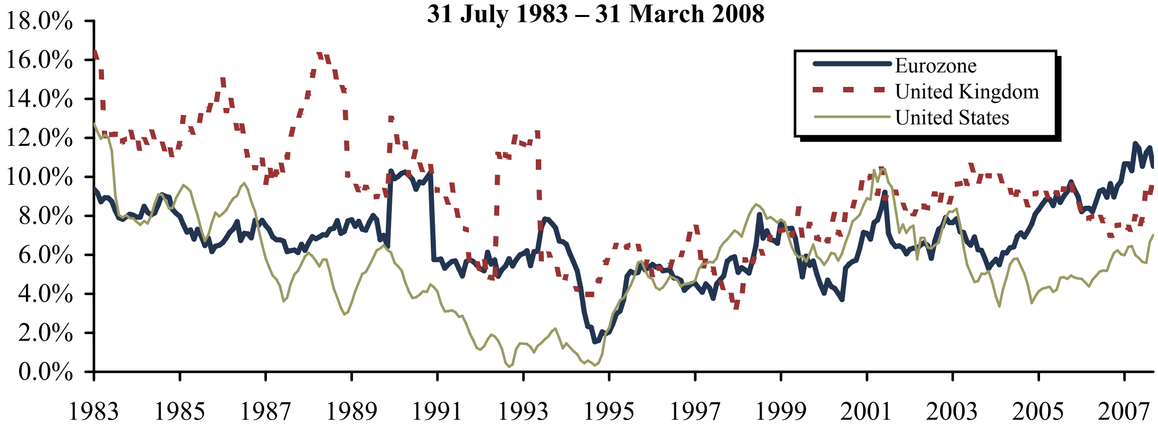
Table C

YEAR-OVER-YEAR GROWTH OF MONETARY AGGREGATES

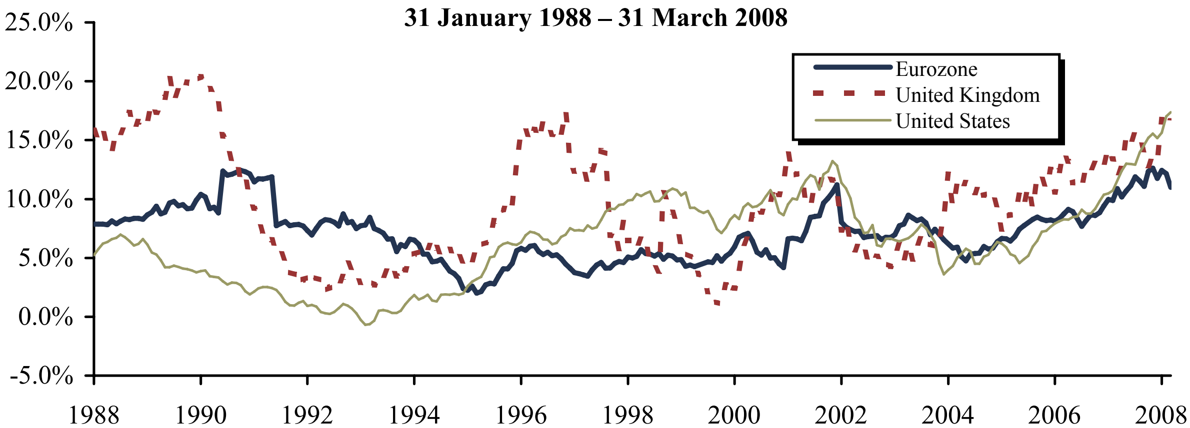
Eurozone Money Supply
31 January 1981 – 31 March 2008



M2 Money Supply for the Eurozone, United Kingdom and United States
31 July 1983 – 31 March 2008



M3 Money Supply for the Eurozone, United Kingdom and United States
31 January 1988 – 31 March 2008

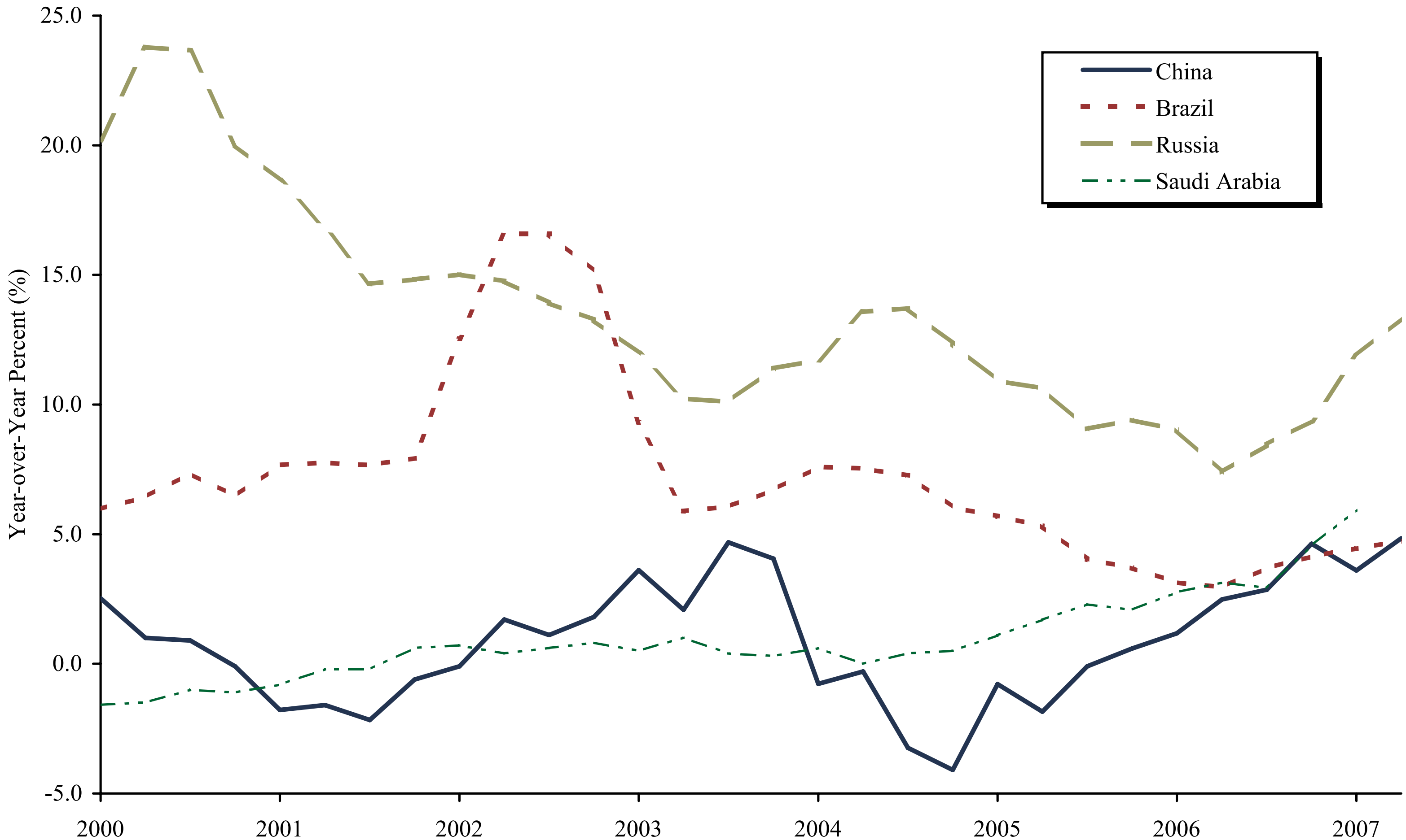


Sources: Shadow Government Statistics and Thomson Datastream.

Table D

HEADLINE CONSUMER PRICE INDEX FOR MAJOR EMERGING MARKETS

31 December 2000 – 31 March 2008



Source: Thomson Datastream.

Notes: Data are not seasonally adjusted. CPI data for Saudi Arabia are through December 2007.