CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

"Emerging Markets Food Inflation to Peak in the Summer" by Dominic Wilson, Goldman Sachs, April 6, 2011

Emerging markets inflation has risen swiftly in recent months, driven in large part by sharp increases in the cost of agricultural goods. Further, tight supplies will likely lead to higher prices over the next few months. However, unless prices double again from current levels—an unlikely scenario without very adverse weather conditions—the slower pace of food price inflation will result in a peak of emerging markets headline inflation later this year. This would relieve pressure on emerging markets central banks to raise rates, which would likely be a positive for emerging equity markets.

Food prices began a vigorous rally in mid-2010, driving the S&P GSCI® Agriculture Index up by 89%, and boosting emerging markets food inflation to 6.8% year-over-year, compared to 4.3% in July 2010. Over the same period, annual emerging markets headline inflation jumped from 3.6% to 4.5%; roughly 80% of the increase can be attributed to higher food prices.

Strong emerging markets demand has been one of the main drivers of rising agricultural commodity prices over the past few years, as rising incomes in developing countries have led to higher demand for food, particularly items such as meat, which require a significant amount of feed. Soybean and corn inventories, meanwhile, are quite low, which should continue to support prices short term. Longer term, increased supply—U.S. farmers plan to increase acreage across most grains—should relieve price pressures by the end of the year. However, given the low starting level of inventories, even moderately adverse weather conditions could push prices sharply higher; in other words, there is price risk in both directions, mainly dependent on weather conditions.

It is also possible that weather conditions turn out to be even worse than the assumed "adverse" scenario, thus pushing prices even higher. However, unless food prices continue to rise at the same pace as their recent spike (almost 90% every seven months), annual food inflation rates will, by definition, decline, as will broader price inflation measures. While some argue that energy prices will push inflation measures higher even if food prices do not, energy makes up only 8% of emerging markets CPI, compared to 26% for food.

The food price spike has contributed to emerging markets central bankers' decisions to raise rates, hurting equity market performance relative to developed markets. However, a slower pace of food price inflation would result in a peak of emerging markets headline inflation later this year. As concerns about a rapid acceleration in inflation abate, equities are likely to be the asset class that benefits most.

"Inflation Risks Remain Skewed Toward the Upside" by Chetan Ahya, Morgan Stanley, March 31, 2011

Inflationary pressures have been building in Asia given increased domestic and external demand, rising commodity prices, and policymakers' hesitance to fully withdraw aggressive monetary and fiscal policies.

Despite investor and consumer concerns, emerging markets price inflation is likely to overshoot current

expectations. Headline inflation in Asia ex Japan ex India accelerated to 4.7% (year-over-year) in February 2011, from 2.9% last June. The consensus view is that emerging markets inflation will peak in the summer; however, in the Asia ex Japan region (emerging markets Asia accounts for about one-third of the MSCI Emerging Markets Index) there are several upside risks. Strong domestic and external demand persists, supply shocks continue to affect energy and food prices, and policymakers are only slowly withdrawing their aggressive monetary and fiscal policies.

In early 2009, regional policymakers pursued easy money policies to counteract collapsing external demand—total Asia ex Japan exports collapsed by almost 30% from peak to trough. Demand recovered largely due to strong local growth, and external demand also increased more rapidly than expected given surprisingly strong growth in developed economies. However, policymakers in Asia remained concerned about its sustainability given concerns over deleveraging.

The European sovereign debt crisis, meanwhile, had a short-lived impact; China, India, and Korea all reported more than a 25% increase in exports from October 2010 through January 2011. Likewise, although the Japanese earthquake and tsunami have depressed demand short term, reconstruction spending could serve as a tailwind for inflation.

At the same time, crop failures and tension in the Middle East have led to food and commodity price spikes. The Commodity Research Board's food and metals indices are 16% and 13% above their 2008 peaks, respectively, and have risen 40% and 48%, respectively, since June, and oil is well above $100. Food and energy compose approximately 40% of emerging markets CPI baskets.

Still, policymakers have been hesitant to raise rates—weighted-average policy rates in the region ex India have risen only from 4.4% in August 2009 to 5.2% in March, and India's rates have risen 200 basis points (bps) from their April 2009 trough. However, inflationary pressures are likely to lead to rate hikes soon—China may hike rates by 50 bps by June, while for the region ex China and India, policy rates could rise 60 bps for the year, compared with 40 bps in 2010.

The key factor that will influence the region's inflation outlook will be the pace of the developed world's (in particular, the G3's) economic recovery. If the developed world's recovery is stronger than expected, inflationary pressures should increase as demand for the region's exports rises. If the G3 double dips, or if European debt woes re-emerge, leading to a slowdown in export demand, downside risks to inflation will rear their heads. It is more likely that the first scenario will play out, and that increased inflationary pressures will plague Asia ex Japan. ■

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