



Plate Tectonics: Global Implications of Inverse Stagflation

Fundamentals have begun to matter once again. The overly correlated markets of 2008's panicked deleveraging, as well as the indiscriminate and undifferentiated bullishness of 2009, are now giving way to bifurcation and decoupling between asset classes. The global recession and credit crunch resulted in massive, unprecedented levels of stimulus being injected into the system as nearly all nations rushed to increase liquidity in tandem. More recently, certain countries have been able to remove some of this stimulus, while other central banks have signaled their intent to keep rates at extremely low levels, continually increasing liquidity via asset purchases and reverse repo operations. Because coordinated liquidity injections of this magnitude are so rare, there has been an ongoing focus on the consequences – whether intended or unintended – of this increase in global liquidity. Under normal conditions, for example, such an acute increase in global money supply should result in inflation as the pass-through mechanism puts more money into the system. Conversely, many market participants are concerned that the stimulus measures taken thus far may not be enough to stave off deflation.

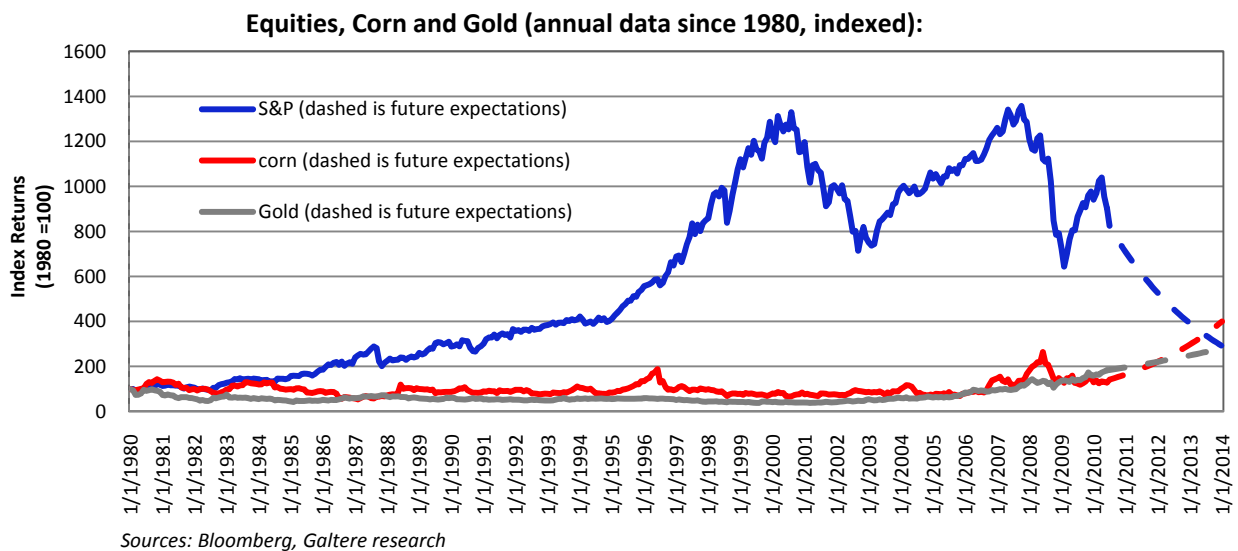
Our view is that inflation and deflation can in fact coexist, a concept that is central to an economic paradigm that we have dubbed Inverse Stagflation. We expect inflation to manifest itself in real assets – chiefly in agricultural commodities and farmland – while paper assets should suffer deflation. This dynamic is part of a structural shift away from the regime of the past 30 years, in which paper assets outperformed real assets five times over (see Figure 1).

In expressing Inverse Stagflation as an investment theme, Galtere focuses on three main threads: a ***structural rise in real asset pricing***, which should outperform over the next decade and beyond, the ***overall decline of global equity indices***; and predominantly ***range-bound fixed income*** markets.



The key to differentiating where inflation may surface lies in one's ability to back up far enough to gain perspective on global supply and demand dynamics. The global economy has evolved such that the catalyst for growth is no longer solely based upon consumption patterns in developed nations, but is increasingly dependent on the growing power of emerging market consumers. As emerging economies consume rather than export their way into growth, their diets are upgraded to include more protein, intensifying the need for grains as both food and feed. According to the *Journal of Environmental Development and Sustainability* (Cornell University: V.8, 2006), up to 8 times as many grain calories are required to produce one protein calorie. As per capita meat consumption rises in emerging markets, the accompanying escalation of grain demand should create upward pricing pressures.

Figure 1



Another factor not being priced into commodities today is water scarcity. According to the United Nations' Food and Agriculture Organization (FAO), 10 - 13 thousand liters of water are required in the production of 1kg of beef, while 1kg of rice and wheat production each requires 1 - 4 liters and 1 - 2 liters of water, respectively. Overall, it is estimated that global water consumption is doubling every 20 years. Additionally, biofuel production has taken root in the global energy infrastructure. The USDA estimates that corn used for ethanol will reach 4.5bn bushels this season, compared to 1.2bn seven years ago. Approximately 30% of the US corn crop will be used for ethanol, the domestic production of which has climbed from 1.6bn in 2000 to 12.8bn gallons in 2009, as reported by the US Energy Information Administration (EIA).

While we expect to see inflation of real assets, much of the Fed's focus and fears in this downturn has been on the output gap and its potential deflationary implications. We agree that the output gap should indeed curb inflation of widgets and paper assets. Capacity utilization in the US hit a low of 68.3% during the recent crisis, and has not yet risen back to 75%. This lies in stark contrast to the post-stagflation peak in the late 1980s of 85.1%, a level matched in the late 1990s during the "productivity miracle era". The recovery of German capacity utilization has also been lackluster, with a current level below 80% compared to a peak of 89.5% capacity utilization in the early 1990s. This spare capacity allows a big cushion for producers, with plenty of room to increase productivity while simultaneously controlling costs.

We have seen this manifest itself in widgets already: for instance, technological innovation and increased



productivity have caused the prices of laptops and other electronic goods to fall dramatically over the past decade. Should real asset prices increase across the board without differentiation, producers might yet be able to absorb some of these costs before passing them along to the consumer. Further, the cost savings from imported deflation out of Asia should continue even with a marginally stronger yuan. These factors would, however, compress profits and lead to slower trend growth while weighing on equity markets. Consumers in developed economies already own a surplus of iPods, cars, computers, even houses – and the pull for greater demand does not appear to exist. We view global equities as the most overinvested, overvalued assets, and the most likely to fall in tandem in the event of another shakeout of the markets. While a sharp retracement of 2008's magnitude may not be on the horizon, equity indices – especially in the US – should underperform other assets, trending downward for the next five to ten years. Further, the ongoing erosion of earnings due to commodity inflation could exacerbate this downturn in equities.

The Inverse Stagflation hypothesis includes a focus on range-bound fixed income markets in developed economies. Stagflation in the 1970s was particularly painful because the environment of stagnating growth was accompanied by high inflation that in turn led to extremely high interest rates, hindering economic activity even further. Although we expect today's scenario to include some price deflation and continued output gap, there should not be the same pressure on the Fed to hike as there might have been thirty years ago. While certain supply shocks could intermittently affect commodity prices, we expect the structural price inflation in grains and soft commodities to be demand-led. Thus, unlike the high inflation / low growth scenario of the 1970s, which many attribute to the OPEC crisis and spike in crude prices, the US economy today should be able to absorb higher prices without putting pressure on rates. Loose monetary policy has historically led to a much steeper yield curve; if a central bank were to monetize debt as the Fed has since 2008, future inflation expectations would put pressure on the back end of the curve. Such steepening did occur earlier this year, with front end rates anchored to Fed policy and 10y yields rising. However, as the market realized that newly created liquidity was not reaching the end consumer, long term rates came back in line and the curve has started to go into a bull flattening. We expect this flattening to continue in the near-term, diverging from the traditional curve assumption of future inflation. It is important to make note of the fact that even with rates at zero, and despite the extraordinary measures taken by the Fed to increase liquidity, the velocity of money has significantly dropped. Having trended lower since the mid 1990s, the velocity of money has fallen even more sharply since the beginning of the credit crunch in mid-2008 (see Figure 2).

Figure 2

Velocity of Money (quarterly data since 1995):



Source: Bloomberg

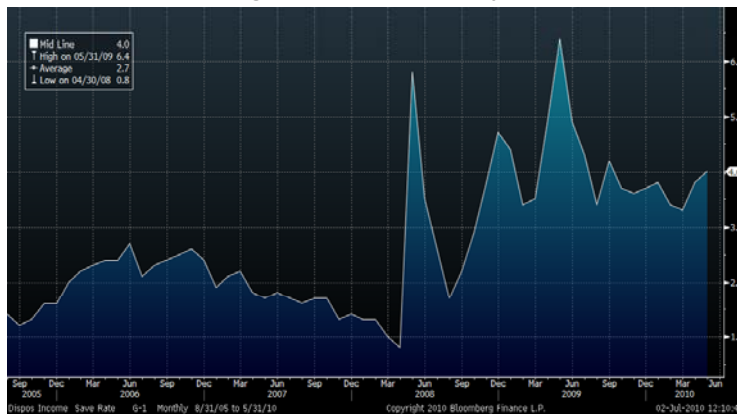
Much of the stimulus provided in the US since 2008 remains barricaded behind the banks, who are not lending to the degree that the government had hoped they might. Instead, the banks are purchasing an increasing number of treasuries, helping keep back-end yields in line, even in the face of increased supply. Coupled with an increase in the savings rate, this breakdown of the pass-through mechanism means that



much less money is being spent on widgets and equities in favor of a higher allocation to coupon-yielding vehicles. Household savings are on the rise in the US (see Figure 3), a potential signal of what we expect could be a paradigm shift in our consumer-driven culture.

Figure 3

US Personal Savings Rate (as a % of disposable income):



Source: Bloomberg

range-bound. Overall, rates should reflect the struggle on the part of investors to balance ingrained patterns of selling bonds in an inflationary environment with their need to earn additional yield in the lower carry/reduced equity return environment.

The next twelve to eighteen months may mark the dénouement of the shift in prominence from equity investments to real asset investments that has been churning since 2007. We see year-to-date volatility as indicative of the natural turbulence that accompanies any regime shift. In this case, as real assets gain acceptance as part of a well-diversified portfolio, the “old power” will fight to maintain its dominance through continued support of equities rather than lose ground. As equities and real assets see-saw throughout this struggle for power, bonds should function as the pivot point between the two, remaining range-bound and supported even during periods of turbulence. The interval from 2007 through 2011 should, roughly speaking, encompass this push and pull before the “new power” – real assets – comes into its own. For those investors with convicted views and a steady grasp of both fundamental and technical value, this move in the seesaw should provide excellent opportunities to put money to work. Just as significant shifts below the Earth’s surface can provoke violent upheavals that in turn form new land masses, we believe that this period market volatility heralds the creation of a fresh investment landscape in which real assets will reign as the dominant investment class.

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