

The inflation dragon is returning



Although the most notable risk for the global economy at the start of 2010 was growth (with many analysts predicting a double-dip recession), much has changed on the global landscape in the space of 12 months. At the start of 2011, rising global inflation is the most significant threat to economic prosperity. Matthew Sherwood, Perpetual's Head of Investment Market Research discusses the 2011 outlook and concludes that central banks have some difficult challenges ahead of them and that for the first time in many years, advanced economy sharemarkets may outperform their emerging economy peers.

Key takeouts:

- The recent floods are set to increase Australian economic growth and inflation.
- Strong growth, loose monetary conditions and higher food prices suggest global inflation will rise significantly, requiring a policy response.
- The environment appears more supportive for advanced sharemarkets over their emerging peers.
- Higher inflation is associated with lower sharemarket returns with a higher contribution from dividends.

Introduction

The Australian summer has certainly not been a good one. We have had some of the worst floods in Australian history, no Australian made it through to the second week of the Australian Open tennis and we had three humiliating test losses to England by more than an innings. In the 19-year period between 1986/87 to 2005, England never won the Ashes and many jokes resulted from this domination. For example, what would Glenn McGrath be if he was English? An all-rounder. What is the height of optimism? An English batsman applying sunscreen. What is the English version of a hat-trick? Three runs in three balls. Now it appears that we are going to be on the receiving end of sporting humour. Nothing lasts forever. If there is one disappointment in Australian cricket and Australian tennis it is a lack of consistency, and this factor is important not only in sports, but also in the equally competitive world of investments.

The impact of the floods is less than initially expected

When the floods in Queensland started in early January there was almost a race in financial markets for who could come up with the most outlandish forecast for its impact on the economy. At that stage such predictions were pure guesswork as no-one really had a clue. Some analysts predicted a decline of around 1% in economic activity and one person even said that Australia is facing a recession. As time has gone on, the receding flood waters have revealed that the damage, although awful and large, is not nearly as bad as first thought. That is not to trivialise the impact on people who have lost possessions, their homes and loved ones. Clearly those losses are enormous and those people will need large-scale assistance through these very hard times.

If we can put those terrible situations to one side, the floods will clearly detract from March quarter 2011 GDP, but this lost activity is likely to be recovered in the June quarter and beyond, as the infrastructure and housing reconstruction commences. The initial deflection from growth will primarily come through lower exports.

Exports will be down due to lower coking coal

While Queensland accounts for around 30% of Australian fruit and vegetable production, it appears that the impact here is modest as much of their harvest was already completed, but there is a sizable impact with respect to Asian vegetables, pineapples, tomatoes and corn. The major Queensland export that has been impacted by the floods has been coal, which represents around 10% of total exports. How many export dollars are at risk depends on the damage sustained to transport infrastructure (ports and rail) and the mines themselves.

Infrastructure damage has been less than expected

Reports indicate that the infrastructure damage has been a lot less than initially estimated and that the majority of ports are already working at over half capacity and this will improve as time goes on. For example, the large port of Dalrymple has reportedly exported around two-thirds of its capacity in January, which is around the average that it operated in 2010 (due to weather-induced factors). Elsewhere, Queensland National reports that rail infrastructure has held up better than expected with major lines open but running at lower-than-normal capacity.

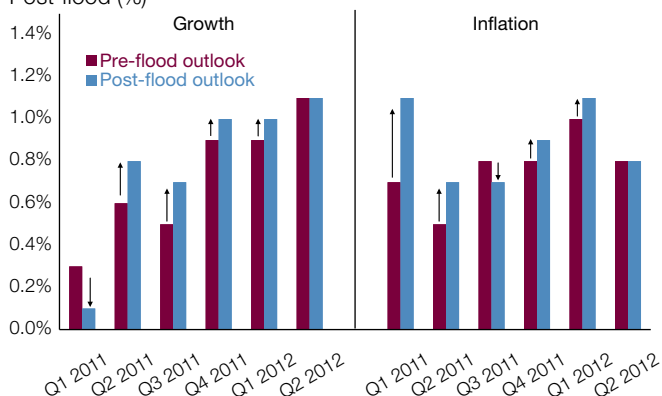
Accordingly, some infrastructure will need to be rebuilt, but overall, the damage is modest (relative to what it could have been). Consequently, a major decline in Queensland exports all boils down to the mines themselves and again there are no reports of major widespread damage, only of limited damage in some mines and to accompanying infrastructure.

The floods may reduce Q1 GDP by 0.2%-0.3% and recover this in Q2

It appears that total Queensland coal exports for the March quarter might decline in the vicinity of 15%, but certainly not 50%, which would be required to reduce Australian GDP by 0.5%. Accordingly, by itself, exports are likely to detract around 0.2% from Australian March quarter 2011 GDP (see Chart 1). It's January now and people (if they can help it) aren't going to wait until after the June quarter to start rebuilding their lives. The replacement of household goods and recovery in other flood-affected sectors should enhance Q2 GDP by 0.2%.

Chart 1: The floods will add to growth and inflation post Q1-2011

Australian Quarterly Economic Growth and Inflation: Pre and Post-flood (%)



Source: Perpetual Investments as at 21 January 2011.

To date, 28,000 homes have been completely destroyed and many more have been partially damaged. This number is very similar to the number of Queensland housing starts in the 12 months to September 2010 and suggests that the dwelling investment contribution to GDP could be large in the June quarter 2011. Overall, a combination of increased consumer spending, higher dwelling construction and reconstruction, and a recovery in exports suggests that the floods may add a net 0.3% to 0.5% to Australian GDP over the next 12 months.

Australian inflationary pressures are set to rise

While economic growth is likely to improve in the recovery, the combination of rising food prices and heightened demand for limited labour resources (which will increase labour costs) will mean that the floods will also add to inflationary pressures (three-quarters of 1% over the next 18 months) with the rate around 3.5% at end-2011. Initially, the Reserve Bank of Australia (RBA) will look through any first round inflationary effects as a result of higher fruit and vegetable prices as this will be temporary.

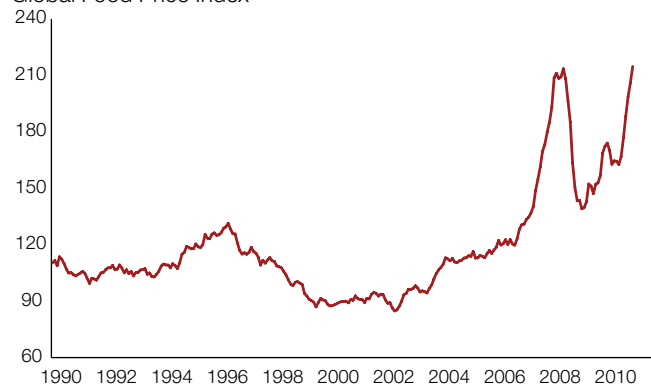
However, the RBA would be more concerned if this temporarily spike in food prices started to impact other variables. There is little doubt that inflation fears have risen over the past month with consumer inflationary expectations (from the Melbourne Institute) rising to around 4½%, which is well in excess of its 2010 average.

... and this will be part of a global trend

However, growing Australian food prices are only part of a global trend. Indeed, northern hemisphere supply shocks in food production appear to be becoming more systemic and have occurred at a time when food demand from Asia is growing rapidly. In the 17 years to end-2006, global food price inflation was 1% per annum, but in the subsequent three years, global food prices have risen 18% per annum and prices have recently returned to record highs (see Chart 2). The largest concern here is that with Asian economies growing at high speeds and with monetary conditions still extremely loose, the flow through of food inflation to other inflation maybe a lot more fluid than normal. The threat to food prices has been amplified by rising energy prices, which is an input into production and transportation costs. Clearly countries where food and energy are over 30% of the consumer price index basket are at risk. These include the Philippines (around 54% of the CPI basket), India (52%), Indonesia (42%), China (41%), Thailand and Malaysia (40%), whereas the G7 economies' share is much lower (around 20%).

Chart 2: Global food prices are back at record highs

Global Food Price Index



Source: United Nations as at 20 January 2011.

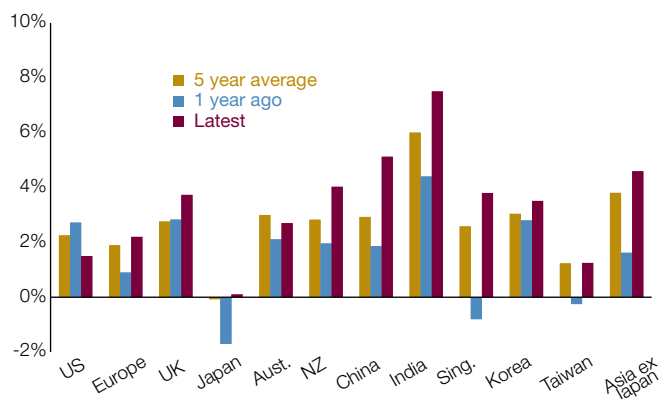
The Chinese deflation shield has gone

The doubling of food prices from 2003 to 2007 did not have a large impact on global inflation primarily due to the disinflationary impact of Chinese manufactured goods. However, this shield will not be evident in 2011 onwards as Chinese labour costs are now rising and its exchange rate is appreciating. Over the past few months China (in November), Brazil, Korea, India and the UK have produced some nasty inflation surprises for markets to digest (things improved slightly in China in December, but this improvement appears to be temporary).

Inflation is now higher than a year ago in every country other than the US (see Chart 3). Inflation is higher in Asian economies as food is a larger component in their consumer price basket, but has risen above its 5-year average also in Europe, UK, Japan, and New Zealand. The last time that food prices were at this level globally (in 2008) it sparked interest rates to rise by a collective 1,400 basis points in 22 emerging economies. Rising inflation is now hindering markets as new data shows the Chinese economy is struggling to slow down (it grew at 10% in the December quarter 2010). Beijing has already raised interest rates twice, reduced stimulus and appreciated its currency to slow growth and the latest growth figures have spooked market fears that rates will need to rise further and this could cause activity to slow sharply.

Chart 3: Inflation is on the rise in most countries

Regional Inflation (%)



Source: Macquarie Equities Limited as at 20 January 2011.

... but the US recovery is strengthening

While, the balance of risks to Asian growth appears to be to the downside, the US economy has continued to surprise on the upside. The US unemployment rate remains stubbornly high relative to the past 20 years, but the US manufacturing and services sectors, consumer spending, industrial production, export growth, retail sales, core durable goods and mortgage applications are demonstrating improved strength, which is indicative of a solid recovery brewing. It is likely that with US unemployment still high at 9%, the US Federal Reserve and the US Treasury will do everything in their power to enhance US growth further.

Developed markets may outperform emerging markets in 2011

Despite the positive US backdrop, conditions are looking less positive in Europe and Japan. Nevertheless, the sheer size of the US economy should provide a platform for a solid rebound in global corporate earnings. While the growth picture is improving across the advanced economies, Asian central banks and governments will have to take action to prevent economic overheating and rising inflation. This suggests 2011 may be the first year in many where there has been positive global economic growth and returns in advanced sharemarkets are higher than those in emerging markets.

The Australian economy is looking temporarily soft

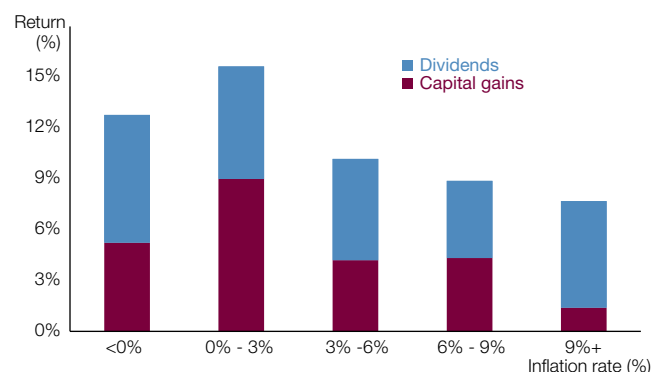
The Australian economy is going through a mid-cycle slowdown as the impact of the higher currency and interest rates over the past year begin to impact growth. Both of these variables have risen in expectation of the mining-induced investment boom and this boom appears to have been delayed until 2012. Accordingly, it is possible that growth will remain sub-trend until the mining boom starts, but when it arrives growth will seriously rise.

Rising inflation has two significant impacts on sharemarket returns

The impact of rising inflation is one that investors should be wary of. Examining annual total Australian sharemarket returns since 1882 indicates that an inflation rate of 0%-3% has been the 'sweet spot' for markets, during which calendar year total returns have averaged 16%, with dividends contributing around 40% of total returns (see Chart 4). However, as inflation rises two important trends become evident. Firstly, the total return decreases (to an average 10% return if inflation is between 3% and 6%, for example), and secondly, dividend income tends to contribute more of the total return as earnings and dividends are both nominal concepts (which rise with inflation), but the associated rise in interest rates negatively impacts share prices.

Chart 4: Share investors prefer low inflation

Australian Sharemarket Returns and Inflation: 1882-2010 (% per annum)



Source: Australian Stock Exchange as at 21 January 2011. Excludes the extreme impact of 1975, 1980, 1983 and 2008 on the annual return.

Implications for investors

The economic risk of 2011 appears to be inflation. The global picture seems to suggest that the risks to major advanced economy growth are to the upside, whereas Asian growth risks are to the downside. The two keys risks in this outlook relates to policy – will the Chinese authorities be able to contain inflation without threatening their medium-term growth outlook, and how quickly and successfully will the European authorities be in dealing with government debt stress? While growth prospects appear brighter than six months ago, consistency in cash flow generation and dividend income growth, and market valuations are things to watch. Companies with more sustainable business models that can deliver earnings growth and dividend income growth in subdued conditions should outperform. But this won't be an easy ride. It is possible that with modest economic growth in the first half of the year, the Australian market might record only modest gains - patience will be key for investors.

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