

Pippa Malmgren on Inflation and its Geopolitical Impact

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The Cold War may have been over for a quarter century, but the inflation-driven challenges that characterized that historical era are heating back up.

After the Berlin wall fell 25 years ago, global economies benefited from two major influences, Malmgren told an international audience of financial advisors last week. One was the large pool of eastern European workers who entered the job market, which brought down wages worldwide. The other was the peace dividend, which permitted western governments to spend less on defense than they would have had the Soviet Union remained intact.

Today, global volatility is back, according to Malmgren, who said that commodity-driven inflation will lead to political instability in emerging markets.

“Those risks are back on the table,” she said.

Malmgren spoke at the annual CFA Institute’s annual investment conference held in Scotland last week. She is the president and founder of both the Canonbury Group and Principalis Asset Management, financial firms based in London. From 2001-2002, she served as financial market advisor to the White House and on the National Economic Council.

Let’s look at the inflationary forces Malmgren expects will imperil the economic recovery and their implications for investors.

The drivers of price increases

Inflation can arise despite the deleveraging and demand destruction that has characterized economies over the last several years, Malmgren said. Commodity price increases are leading the way, she explained, and they are being driven by capital-intensive businesses that need access to the credit markets.

Farmers, for example, rely on credit to purchase seed and other raw materials. Their lack of access to credit during the financial crisis caused seed sales for companies like Monsanto to collapse, Malmgren said. In the absence of decreased demand, supply shortages across the agricultural production cycle have led to higher food prices.



Mining is similarly capital-dependent, as are other extractive industries, including oil production. Many of the marginal suppliers to the extractive industry went bust following the crisis, leaving those who were left standing positioned to raise prices.

Price increases are happening now, Malmgren said, as consolidation across a number of industries has benefited the stronger companies. Farmland prices have spiked in the Midwest and oil prices, at least until very recently, have risen.

Quantitative easing has also played a role in driving commodity price increases, Malmgren said, by causing investors to shun paper assets, particularly bonds, and prefer hard assets. Hedge funds have been going long the “breakfast box,” she said: orange juice, pork bellies, grains and cereal.

Oil producers, however, are not ready to deploy their capital to increase production, according to Malmgren. In her conversations with oil executives, she has found that there is a widely held belief that the normal price of oil is \$35/barrel, and “anything above that is temporary and exceptional,” she said. Moreover, she said, it would take roughly five years of oil above \$100/barrel before senior executives would invest in increasing capacity.

Mining executives she has met with have told her that deflation is the greatest risk they face, and they prefer to invest in support and logistics rather than exploration and production, especially given the instability in northern Africa.

“High prices don’t necessarily give you more production,” Malmgren said.

Inflation in emerging markets

Most investors today have yet to experience an episode of serious inflation, with the most recent having been in the 1970s, Malmgren said.

But that may soon change. The disconnect between supply-side constraints and the prevailing unwillingness to increase production is feeding inflation, particularly in emerging markets, she warned.

Malmgren’s explanation stems from the fact that workers in emerging markets are uniquely vulnerable, because half their income is spent on food and energy, the main sources of inflation today.

In the US, that phenomenon is less visible, because core CPI does not include food and energy prices. But in emerging markets, inflation is rising rapidly. Malmgren said the actual inflation rate in China is closer to 10% than its reported rate of 5%. In India, where the official rate is 16.5%, she said the prices are up for core food and staple items by more than 100% in the last year – and some by even more than that.



Inflation in those countries is leading to civil unrest, Malmgren said. Workers are objecting to a “fundamental unfairness in the distribution of the wealth, power and assets in the society,” she said.

Workers in emerging markets are becoming impatient and are demanding jobs and immediate income, according to Malmgren. Officially, there are 30 million unemployed Chinese, but she said the figure is closer to 50 million.

Wage demands are particularly acute in Bangladesh. In December, workers there went on strike for three days, at which point the government doubled their wages, Malmgren said. Then they went on strike for three more days, seeking even higher wages.

Workers are unwilling to believe that economic growth alone will deliver a better outcome, she said, and they want to be paid more now.

Malmgren said that emerging market inflation is at the heart of recent political unrest. “Workers don’t suddenly wake up one day,” she said, “and decide that of all days today is the day that they need to riot.”

That was true in the past. She said that the Tiananmen Square confrontations took place against a backdrop of 14% inflation. If China is already at 10% inflation, as she contends, then similar episodes will unfold soon.

“Inflation is the catalyst,” she said, “that makes people conscious that they are getting squeezed and that they want to address the fundamental unfairness.”

Tunisia faced inflation prior to its political upheaval, she said. “It always hits the most marginal, vulnerable countries first.”

Roughly one third of all African countries are facing some kind of civil unrest and protests relating to rising prices, according to Malmgren.

Malmgren said that the next country to face unrest could be Vietnam, where inflation is particularly strong.

Investment implications

“It is a mistake to think that geopolitical issues are contained in the Arab world,” Malmgren said. “It is a mistake to think that this will not impact your portfolios and your investment strategies. “

She identified a number of themes that will affect investors.



Prices coming out of emerging markets will be higher, she said, and this will be most evident in the cost of clothing in the US, which has been in a secular decline over at least the last two decades.

Executives in capital-intensive industries will be reluctant to invest in new production, fearing civil unrest. That will keep oil prices from experiencing sustained declines. Malmgren said that investors should pay close attention to Bahrain, which will be the “epicenter of the conflict between Sunnis and Shiites.” She said the Saudis are trying to defuse the situation in Bahrain by providing that country with additional funds, but she is not confident that strategy will result in lower oil prices.

Investors should pay close attention to reported and actual inflation numbers, she said. In that respect, she noted that the breakeven inflation rate based on the TIPS market in the US has not been moving up, indicating that investors do not currently expect much inflation. But, she cautioned, WalMart’s CEO Mike Duke recently warned of incipient price increases that will be passed on to customers, and this could be a harbinger of a trend among the very largest U.S. companies.

Indeed, Malmgren said she has heard that major US companies are now buying supplies four to six months in advance, in anticipation of price increases.

Candy bars, strangely enough, represent another sign that inflation in the US may be stronger than the markets anticipate. Thanks to inflation in countries such as Ivory Coast, cocoa prices have risen, and in response Cadbury has reduced the size of its chocolate bars by two squares while holding their price constant.

“If you want pricing power,” she said, the implication is to “own brands that can pass on price increases.”

Overall, the implications for US companies are largely positive, she said. US agriculture will perform well, and rising prices in emerging markets will cause a migration of manufacturing back to this country. US companies have the strongest brand names, she said, and will have the greatest power to pass along price increases.

Asian economies will be forced to move up the value chain and produce more finished goods rather than components. They will need to invest in infrastructure, and that will benefit US suppliers, who will help them build roads and rail networks.

Black Swan phenomena are rare in geopolitics, she warned, and it should be possible to forecast the next wave of civil unrest. Governments will need to focus on national security and feeding their populations, she said, and on keeping unemployment low.

“Politics is back on the stage as a main character in the play,” she said. “Governments no longer just set the rules for the landscape, but they are intervening all the time.”



Malmgren admitted that her views are out of the economic mainstream, as many continue to believe that deflation will dominate in the years ahead. But she cautioned her audience not to dig into an “intellectual fox hole” on this issue.

“It’s not black and white, and it’s important to engage in and analyze alternative scenarios and think about how they might play out,” she said. “Markets are very quick to respond to changes in price levels, and that is what we are beginning to see happen.”

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