



## Global Outlook – Tailwinds to Headwinds

Over the past year, as the world focused on the U.S. credit crunch and the usual deflationary implications of a U.S. recession, inflation snuck into the room. The fog created by the sub-prime crisis provided a good cover, but now investors are beginning to wake up to the problems that accelerating inflation could have for the global economy.

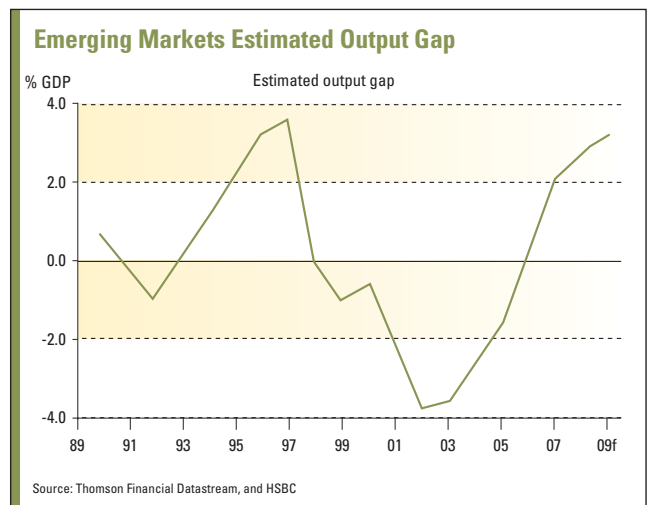
It will have its biggest impact on emerging markets, which have become the engine of global growth. Unfortunately, many developing countries are ill-equipped to deal with the combination of a global slowdown and a commodity price shock.

Emerging markets came of age in the past decade by growing exports to the developed world and strengthening domestic demand. They benefited from tailwinds that included surplus labour, capital and energy, which all led to strong growth with relatively low inflation. As shown in Chart 1, the Asian crisis in the late 1990s was the original source of the slack that allowed for non-inflationary growth in much of the world. It temporarily lowered global demand for commodities, created the global equity bubble, and later the property bubble. It was chapter one in the saga. Since 2005, the slack has gradually come out of emerging market economies as labour and asset prices began to move sharply higher. The fading tailwinds are becoming outright headwinds and the latest chapter is now being written.

This cycle has been sped up by the U.S. credit crisis. Since last August, the Federal Reserve has slashed its fed funds rate by 325 basis points to 2.0% in an effort to shore up the U.S. financial system and stop the economy from slipping into recession. Rate cuts led to a falling U.S. dollar, which in

turn caused a spike in commodity prices. This is driving inflation higher – especially in the developing markets.

Many developing countries peg their currencies to the U.S. dollar, which means their monetary policy is pegged too (see Chart 2). What was a remedy for U.S. financial markets – lower interest rates and cheaper money – just added fuel



*Chart 1: The chart of the emerging markets' estimated output gap (the gap between the actual and the potential economic output) shows how these countries gave the world a deflationary shock in the late 1990s. The Asian crisis temporarily lowered demand for commodities and became the original source of the slack that allowed for non-inflationary growth in much of the world. Since 2005, that slack has disappeared, which has led to the inflationary pressures the world is experiencing today.*

### Is Fed Chairman Ben Bernanke setting interest rates for the world?

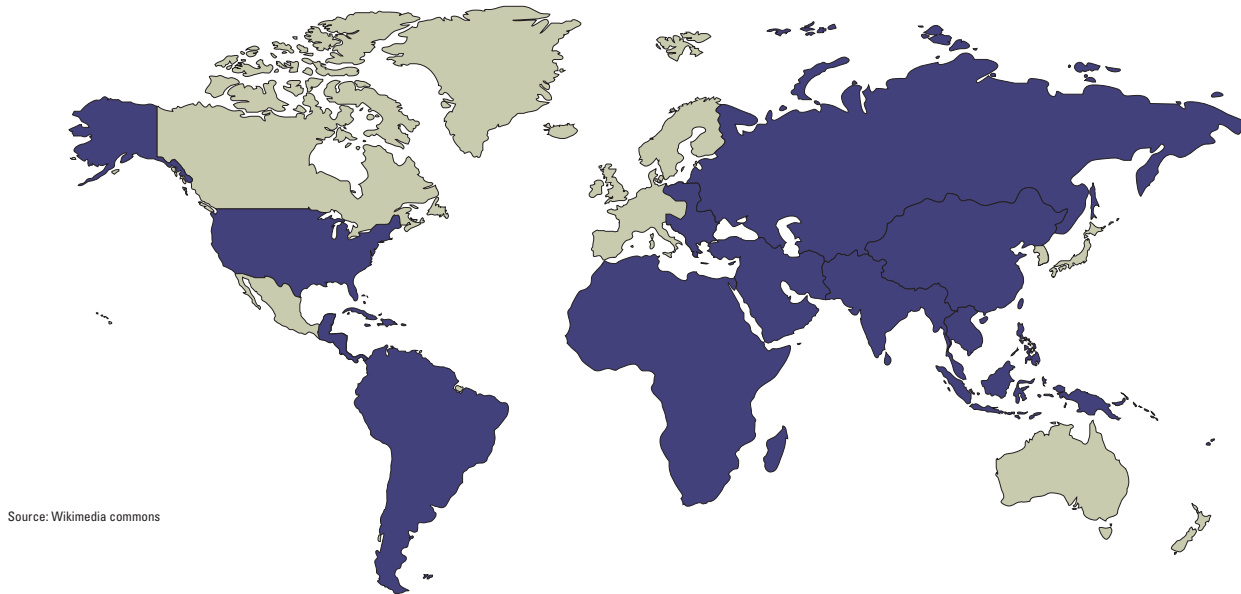


Chart 2: This map highlights the U.S. and areas of the world that tie their currency to the U.S. dollar – which means that their monetary policy is linked as well.

to the fire in these countries, which were already experiencing strong growth and rising prices. Weakening currencies are leading to imported inflation as well. Now, in some areas, inflation is running at 20% or more, while interest rates are at 6% or less – which creates massively negative real interest rates. As a result, many savers, like those in the Persian Gulf and Asia, have turned to real estate in search of returns. And this has further fuelled the global property boom.

On a recent trip to the Gulf region, I saw the extent of the world's largest construction boom. In countries such as Saudi Arabia and the United Arab Emirates, billions of dollars are being spent as new cities are springing up in the desert. Manufacturing plants are hastily being built to meet the region's increased need for steel and other materials to keep up with the construction demand.

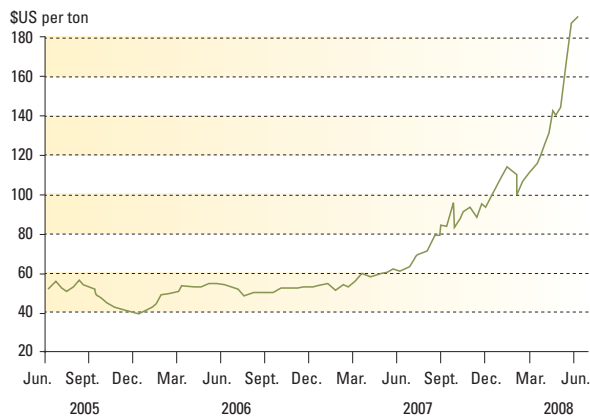
All this is at risk in the face of the twin challenges of a U.S.-led global economic slowdown and a worldwide oil and food price shock.

According to forecasts, world growth is expected to be moderate this year and next, with developing countries picking up the slack for the developed world as the U.S. slowly recovers. But this outlook will come into question, as rising commodity prices, particularly higher prices for fuel, threaten economic output. Oil prices have increased more than 30% since the beginning of the year, while the price of thermal coal – the primary fuel source for electricity, especially in emerging markets – has skyrocketed, rising nearly 80% (see Chart 3).

Higher energy costs are pushing up food prices. In some countries, food accounts for 30%-40% of the consumer price index. In China, for example, food prices have risen 22% in



### Thermal Coal Prices Outpace Oil



Source: Bloomberg

*Chart 3: Prices for thermal coal, which much of the world uses as a source of energy, have tripled in the past year – far outpacing the rise in oil prices and adding to global inflation pressures.*

the past year, while non-food prices have gone up only 1.8%. The challenges and risks to the global economy have risen significantly over the past year as a result of these rising prices.

As a global growth scare takes hold, there is going to be fallout. For many years, Asian economies and Middle East oil exporters ran large trade surpluses. They piled these surpluses into foreign exchange reserves, mainly U.S. treasuries, in order to prevent their currencies from rising. This pushed down global bond yields and contributed to the U.S. housing bubble, which subsequently ended with the sub-prime meltdown. As interest rates rise to meet the inflation threat, the property boom in Asia and other parts of the world will screech to a halt.

Rising energy costs will put pressure on China and others to reduce subsidies to their industries. In China, for example, subsidies led to the creation of a huge aluminum smelting sector – one of the most energy-intensive industries there is. How does it make sense for China to account for 30% of the world aluminum production capacity, when it

imports massive amounts of oil at world prices to meet its energy needs?

There will be slowing exports from the emerging markets to the U.S. and Europe, as developed economies cool. This will translate into slower growth in the developing world unless the slack can be picked up domestically.

The emerging market universe will split into the haves and have not's. The strength and structure of an underlying economy, along with government policy actions, will help dictate how a given economy responds. The dividing line will be between those that have a current account surplus and access to capital and those that face rising current account deficits and need to attract capital. The scorecard will be the currency and foreign exchange reserves. While both groups will face difficult policy choices, there will be significantly more policy flexibility for the haves.

Regions such as India, Indonesia, Vietnam and Eastern Europe, which are faced with rising fiscal and current account deficits, will have few choices with their limited ability to attract capital. Others, like China, with massive foreign exchange reserves and a strong fiscal balance sheet, will have many more options. These political choices will have an increasingly bigger impact on the markets. Some governments may not be able to cope with slower growth and high inflation, so expect political instability. Countries will have to choose between building roads and keeping the lid on rising food costs. Despite their fantastic recent growth record, investors need to be very cautious about emerging markets.

Ben Bernanke's recession-fighting tactics at home have set off an inflation shock throughout the dollar bloc countries. Whether that boomerang comes home to the U.S. is the most important question facing financial markets.

We expect concerns about growth to lead to a pullback in commodity prices. However, we feel that the long-term demand for energy will remain strong and that this secular resource boom is not coming to an end just yet.

In Japan, a touch of inflation will mean the end of a 20-year bull market in bonds. Japanese stocks will become more interesting as investors shift back into equities.

Currently, the Signature funds are positioned cautiously with high cash content. With the expectation of modestly rising interest rates on the horizon, our allocation is away from government bonds. Instead, we favour investment grade and high-yield corporate bonds. Signature High Income Fund is focused on high-yield securities and we think this fund has exceptional prospects.

Our expectation of a global growth scare remains intact, only now it will be accompanied by a global inflation scare. We think growth will decelerate sufficiently in 2009 to quell the inflationary storm. However, if emerging market governments find inflation fighting unpalatable, growth may run stronger for longer and deliver a boomerang back to Bernanke.

At Signature, we believe this double whammy will lead to ominous headlines and turmoil in the markets – and investment opportunities for our clients.



*Eric Bushell*  
*Chief Investment Officer*  
*Signature Global Advisors*

