



Which-flation?

In the first half of 2008, we saw most countries report record inflation rates based mainly on cost-push factors stemming from the commodity price rally. As this rally slowed and eventually turned into a bear market in the latter part of 2008, we have seen inflation correct as well, albeit with a lag. One of the major questions on investors' minds is whether we will enter dangerous deflationary territory as a result of the worldwide recession, or whether the attempts at reflation via unprecedented massive fiscal and monetary stimulus packages will actually over-stimulate economies and result in high inflation or even hyperinflation. To distinguish between some inflation-related terms, reflation is basically the intentional reversal of deflation through monetary actions. Deflation is defined as the general decline in prices, while disinflation refers to a slowing of the rate at which prices increase. Stagflation is a condition of slow economic growth and relatively high unemployment - a time of stagnation - accompanied by a rise in prices, or inflation.

This piece examines the evidence supporting the possible outcomes and attempts to determine the most likely one.

The backdrop

Given the fluctuations in economic growth, unemployment and inflation that normally characterize the ups and downs in the business cycle, it is customary for policy makers to engage in counter-cyclical policy action, in an attempt to ensure that the cycle does not veer too far in any one direction.

These counter-cyclical policies depend on the general rule or premise that there is a trade-off between inflation and unemployment, and that a healthy balance between the two is ideal. In inflationary high-growth periods, unemployment is generally low, and contractionary policies are adopted to prevent the economy from overheating – i.e. state spending is reduced and / or liquidity is absorbed. Conversely, when growth is slowing, jobs are lost and disinflation or deflation sets in, an expansionary stance is adopted – i.e. state spending grows and / or liquidity is injected - to create employment, stimulate economic activity and growth, and maintain an acceptable level of inflation.

The sub-prime mortgage crisis which began in 2007 caused ripple effects leading to the worldwide credit deep freeze and global recession we are witnessing today. Most Governments and Central Banks, which scrambled to tighten monetary policy late in 2007 and into 2008 to curb inflation, are now in full throttle fiscal and monetary expansion mode, having shifted their focus in the latter part of 2008. The motivation for this abrupt shift in monetary and fiscal stance is simply to avoid or to minimize the length and depth of the recession, which threatens to be far worse than recessions of the past, given the slew of record setting negative market and macroeconomic data seen every day.

The source of inflation

Most of the inflation we saw in the first half of 2008 was a result of cost-push factors – where commodity prices increased input costs. However, a portion of this spike in inflation had its demand-pull roots in the prior years, as a ballooning middle class in the developing world placed a strain on global supplies for energy, food, housing and consumer goods (and their respective inputs). We know that generally, supply responds to demand, but with a lag of course as the factors of production take time to assemble, and goods take time to be produced and shipped to their end users.

Early in 2008 when demand outstripped supply, prices surged until a combination of increased supply, and dampened consumer and investor confidence hit the market. This caused an abrupt reversal in that price trend late in 2008. As US and European consumers shifted to positive savings, and hence less consumption, supply outstripped demand and will continue to do so until supply contracts and / or the consumer starts buying again, returning inventory levels to normal.

Given that inventory levels are at record highs around the world, there has been a significant slowdown in international trade, particularly for Asian goods destined for North America. This is evidenced by the data on shipments to and from the Long Beach container port in California, which were down by over 30% y-o-y in December 2008, while the percentage of containers that are sitting empty is approaching 40%. The World Bank announced in December that international trade will shrink in 2009 for the first time in more than 25 years as economic expansion slows and commodity prices slide.

This abrupt and severe drop in demand and trade has led to a massive shedding of productive capacity worldwide, as demonstrated by record levels of layoffs and factory closures / mothballing.

The Measures

We have seen most of the developed world rush to loosen monetary policy AND expand state spending concurrently. While this combined approach is somewhat unusual, it is thought to be necessary at this time to simultaneously address the liquidity / credit paralysis in the financial sector, and the effect that this has had on the real estate sector via the loss in confidence, business closures and job losses.

In **the US**, the Government has pledged USD8.5 trillion in liquidity support for financial markets, and has so far spent USD350 billion of that to bail out banks, while an economic stimulus package approximating USD900 billion is being debated in the Senate. This stimulus package includes tax credits to homebuyers and a massive infrastructure spending plan. The Fed funds rate was lowered in December 2008 to a target of 0-0.25% - the lowest level in history. The M1 measure of money supply recorded growth of 17% y-o-y in December 2008, but credit growth remains in negative territory.

The policy rate in **the UK** now stands at 1% which is the lowest since the Bank of England was founded in 1694. The Government has authorized the BoE to inject up to GBP50 billion (USD73 billion) via the purchase of debt. The Government has also announced a GBP20 billion package of tax cuts to boost consumer spending.

The **European** Central Bank said that policy makers may cut their benchmark rate by a half percentage point to a record low of 1.5% in March after leaving it unchanged at 2% on 5 February 2009. Germany, Europe's biggest economy and the world's largest exporter announced a stimulus package of EUR80 billion (USD103 billion) over two (2) years to support the economy. This amounts to about 1.6% of GDP, and is the largest stimulus package in Europe.

China has already started spending the second part of a USD590 billion stimulus package announced in November 2008, as Governments around the region including Singapore and India have pledged more than USD685 billion in fiscal stimulus and injected billions more into their financial systems. China's policy rate was slashed by 2.16 percentage points in 2008 and now stands at 5.31%. M2, the broadest measure of money supply, surged in December 2008 by 17.8% year on year, and the Central Bank is targeting another 17% increase in 2009.

The sum of all these stimulus packages mentioned, which of course only represents a subset of all interventions worldwide, amounts to a staggering USD11 trillion, which will be spent or injected over the next year or two. While this figure seems enormous, when taken into context and compared to the wealth lost on equity markets over the past year, which is estimated at USD7 trillion, the former figure seems much less excessive.

There are three most likely scenarios that can play out henceforth:

1. There is a V shaped recovery where the stimulus packages take effect quickly, and economies begin to recover from the recession this year – the optimistic scenario. If the optimistic scenario is realized, the rapid return of normal spending patterns amidst severe supply constraints (caused by the mothballing and business closures mentioned earlier) could cause a short-term highly inflationary period resembling that of H108. It has been suggested that under this scenario, we could then witness a W shaped recovery as the initial recovery is cut short.
2. There is a U shaped recovery where the interventions don't take effect for much longer, and recovery begins in 2010 - the baseline scenario. If the baseline scenario plays out, reflation will have taken place, but at a more measured pace than under the optimistic scenario, such that supply would have a longer period of time to recover, and keep up with demand.
3. There is an L shaped recovery where the interventions fail to reinstate consumer confidence and can't convince consumers to revert to more normal spending patterns for some time. Recovery can take a few years – the pessimistic scenario. Assuming the pessimistic scenario plays out, it is possible that the deflationary trends now seen in the developed world would trickle down to the emerging markets, turning their disinflation into deflation - which can assume a dangerous downward spiral.

Which will it be?

It is clear that we are by no means out of the woods, as the slightest upset in the market causes a flight to quality and indices to tank. Consumers are not spending, banks are not lending, and policymakers are still scrambling. While there is virtually unlimited negative macroeconomic data coming out of the US, UK, Europe and Japan, there is growing evidence from financial markets however, that risk aversion is on a downward trend, thus implying that confidence is slowly returning. Some markets are even showing signs of nascent recovery as follows (typically the markets are a leading indicator of where the macroeconomy is heading):

1. The S&P 500 is up from its low of 752 in November 2008 and is largely moving sideways.
 2. All major commodity futures indices are up from the lows touched in December.
 3. JP Morgan's EMBI index which reflects Emerging Market sovereign bond spreads over US Treasury yields has maintained its overall downward trend (indicating falling risk aversion) since its peak towards the end of November 2008.
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4. The TED spread - the difference between what banks and the US Treasury pay to borrow for three months, is an indicator of the perception of risk in the financial sector. The TED spread has maintained a steady downward trend and has settled just below 100bps from 464 bps in October 2008.
5. The VIX or volatility index has been declining steadily from its 20 November peak of 80.86, and now stands at 43.73, indicating that the level of volatility has been falling.

Assumptions and conclusion

If the predictive nature of the market holds true, and provided we are in fact seeing the beginning of a recovery in the market, we may begin to see signs of economic recovery this year. For this recovery to be sustained, whether U shaped or V, the USD11 trillion stimulus packages must be accompanied by an increase in the velocity of circulation of that money – a factor which has remained elusive thus far given banks' reluctance to lend. However, the broad-based nationalization of many banks and financial institutions worldwide would support this goal, as there is talk of banks being mandated to lend in exchange for liquidity. If these major assumptions do in fact play out, the question of whether there will be moderate inflation or high inflation would depend on the timing of the recovery, and the ability of supply to keep pace with demand, as discussed earlier.

By all indications, the extent of job losses in the US is set to increase, and regardless of the scale and scope of liquidity injections and fiscal stimuli, consumers will continue to raise their propensity to save for a rainy day if storm clouds are hovering. This factor is likely to be the biggest drag on any recovery

If all these assumptions hold therefore, it should be more likely that the recovery would begin towards the end of 2009 giving supply more time to respond to demand. Under this scenario, which the author believes to be the most likely outcome, inflation should not revisit the highs seen in 2008. The least probable outcome is that employment levels recover rapidly, and all other assumptions hold, we should then witness high inflation and monetary policy tightening towards the end of 2009 into 2010.

FINANCIAL & ECONOMIC INDICATORS

As at 5 February, 2009

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	91.23	90.03
Euro	1.28	1.30
Jamaica	86.55	85.95
Guyana	205.70	205.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	41.17	41.44
Natural Gas (US\$/mmbtu)	4.84	4.70
Gold (US\$/Troy Ounce)	914.55	908.65

Eurobond Indices (As at 5-February-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	-3.26
JP Morgan EMBI+ (Basis points)	640
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	4.46

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0-0.25	0-0.25
Euro Zone	2.00	2.00
Japan	0.10	0.12
Brazil	12.75	12.75
Trinidad	8.75	8.75
Jamaica	13.50	13.50
Barbados	3.00	3.00

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.27	0.22
US 10-Yr Treasury	2.91	2.86
3-month UK Libor	2.14	2.17
Japan 90-day T-Bill	0.38	0.38
Brazil 90-day T-Bill	12.05	12.72
TT 90-day T-Bill	6.32	6.32
Jamaica 90-day T-Bill	22.33	22.33
Barbados 90-day T-Bill	4.33	4.33

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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