



Adviser Soapbox

Inflation Stoked

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In the wake of recent volatility in equity markets around the world and growing anxiety about the potential for problems in the U.S. mortgage and housing markets to adversely affect the broader economy, inflation worries have taken a back seat to apprehension about slowing growth.

But despite the increasingly gloomy news coming out of the United States, global markets and economic data continue to paint a brighter picture.

For example, copper prices, which have a pretty good track record of forecasting changes in the economy, have climbed more than 20% since the start of the year after sliding throughout the latter half of 2006. The recent gains are all the more remarkable when one considers the enormous amount of copper that is used in the construction of new homes--which suggests that other areas of the global economy are picking up some of the slack of the beleaguered U.S. homebuilding sector.

Signs of strength are also evident in a number of economically sensitive equity market segments around the world, such as German retailers and construction companies, which since the start of the year have surged 10% and 20%, respectively. Meanwhile, previously widespread worries that both China and Japan would experience slowdowns in 2007 have thus far proved unfounded; Europe is witnessing very strong demand growth despite the value-added-tax hike in Germany earlier this year; and important emerging markets such as India and China continue to show signs of acceleration, not contraction.

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Notwithstanding this evidence of economic vigor, concerns about the outlook for economic growth continue to dominate the discussion, and central banks--which remain quite vociferous about still-elevated inflation levels--appear to be focusing more on the potential for a slowdown.

The U.S. Federal Reserve decided to delete from its post-meeting statement in March a previous mention of "firming" rates -- an adjustment that was widely seen as clearing the way for rate cuts later this year. The Bank of Japan increased rates to 0.50% on Feb. 23, but it made clear that changes going forward are likely to be gradual. Meanwhile, Brazil has cut rates twice since the start of the year; Mexico has held rates steady at three consecutive meetings (despite an up-tick in inflation); Indonesia has cut rates twice; and the European Central Bank has boosted rates at just one of its three meetings thus far this year (by 0.25%), after hiking five times in 2006.

Further reflecting the growing consensus that inflation is less likely to be a problem going forward is the performance of equity markets even in those countries in which central banks are taking a somewhat more aggressive approach to monetary policy. On March 17, the People's Bank of China raised rates in an attempt to curb inflation and address concerns about a perceived asset bubble, yet Chinese stocks rallied strongly on the news, with the Shanghai Composite Stock Exchange Index hitting a new high just three days later--recovering all and more of the 9% the index lost in just one trading session on Feb. 27. And in the U.K., equities saw strong gains immediately following a surprise rate hike by the Bank of England on Jan. 11. (The FTSE 100 Index remains up 1.2% year-to-date following the February/March global equity market correction.)

Indeed, with all major global stock markets having bounced strongly off the February/March correction lows, it certainly seems as though tighter global monetary policy in response to rising inflation is much less of a concern today than it was last summer.

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But, is the now-widespread view that slowing growth reduces the risk of future high inflation supported by the current data and the historical evidence? Perhaps not.

Ironically (but perhaps not surprisingly, given current concerns about slowing growth), inflation worries have abated over the past year despite the fact that many measures of global inflation have been rising during this period:

--In Canada, Core CPI has been trending up since early 2004 and now stands at the highest level since March of 2003. Country-specific play: iShares MSCI Canada Index.

--South of the U.S. border, headline consumer prices in Mexico have also moved higher over the past seven months and are now above the Mexican central bank's 2% to 4% target range, while Core CPI has risen from below 3% to nearly 4% since the start of 2005. Country-specific play: iShares MSCI Mexico Index.

--Across the Atlantic, the United Kingdom's Retail Price Index jumped 0.7% month-over-month and 4.6% year-over-year in February, the largest percentage gain since August 1991.

--Consumer prices in continental Europe have also shot higher over the past year, with Core CPI in the Eurozone now pushing toward 2%, up from 1.2% in February 2006.

--In China, inflation accelerated in February on the back of 17.8% growth in China's money supply (the fastest pace in six months), with increases seen in the cost of eggs, meat, alcohol and housing rents. Food prices, which make up a third of China's consumer price index, surged 6% year-over-year in February, up from only 0.3% in September of 2005. And wages have been rising at a double-digit annual pace in some areas. Country-specific play: iShares FTSE/Xinhua China 25 Index.

--In India, the world's second-fastest-growing major economy, inflation has been running at more than double China's rate. And as we observed in the Dec. 19, 2006 issue of *Inside Global Markets* ("[Hedging Asia: China vs. India](#)"), the pace of bank lending in India has been growing well above the growth rate of bank deposits, and easy access to bank credit has caused real estate prices to soar, with properties in major metropolitan areas having climbed as much as 300% during the last three years. Country-specific play: The India Fund.

--In Japan, which only recently has appeared to emerge from a decade-long deflationary nightmare, land prices in 2006 posted the first general increase in 16 years--residential land prices rose an average of 0.1% year-over-year, while commercial property prices jumped an average of 2.3%, following an average 2.7% decline in both categories in 2005. Country-specific play: iShares MSCI Japan Index.

--And in the United States, both core producer prices and core consumer prices came in above consensus expectations in February, at 1.8% and 2.7% (respectively, year-over-year), and Core CPI has now been at or above 2% (the top end of the Fed's stated target range) for almost three years.

Given all of these trends and others, even if forecasts for a global economic slowdown are proved correct (the jury is still out), it might still be a mistake to assume that this will necessarily translate into a more benign inflation outlook.

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Several of the disinflationary forces that were seen during the late-1990s expansion (including weak Asian domestic consumption, a strong U.S. dollar and lower commodity prices) have reversed during the current economic expansion and threaten to keep import prices high. What is more, the oft-referred-to correlation between slower growth and lower inflation (or vice versa) has not always held up in practice, and the evidence suggests that commodity prices, which have seen large gains since early 2002, are perhaps a more reliable indicator of future consumer inflation trends.

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