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March 11, 2011

Inflation Pressures Likely to Result in EM Currency Policy Shift

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In last month's report, we highlighted our view regarding the impact growing inflation was having on emerging markets ("EM") economies and politics, and we briefly discussed in our macro report our view that "Money Wars" would be an important theme for 2011. The premise was that EM monetary and currency policies have both been highly stimulative and that this year would likely see a move towards somewhat tighter monetary policy but significantly stronger EM currencies. This month, we explore in more detail our thoughts on why we believe that most of the adjustment is likely to come via the currency market and also highlight some signs that this move has already begun.

Table 1: Price Inflation for Selected Commodities

Index	Jun-10	Dec-10	Change
S&P Corn	299.48	519.30	73.40%
S&P Wheat	325.87	538.93	65.38%
S&P Soybean	358.31	557.02	55.46%
S&P Cotton	108.68	206.05	89.59%
S&P Sugar	169.05	338.11	100.00%
S&P Palm Oil	134.69	225.74	67.60%
S&P Livestock	240.51	267.27	11.13%
Brent Crude	73.87	94.30	27.66%

For many nations, any significant increase in food prices can be problematic on the inflation front. Last month we provided tables that showed the food weighting in the CPI basket for EM typically represents 20%-50% of the index, whereas in developed markets the weighting is typically around 10%-20%. In addition, many emerging nations have food and fuel subsidies that worsen inflation problems through expansion of the budget deficits. Commodity price inflation is obviously very real, as seen in Table 1, which has compelled emerging nations to respond.

Many central banks in the emerging world have already been active in reducing liquidity via interest rate hikes. However, they are fighting a losing battle as the ex-ante real rates are virtually unchanged now compared to the end of 2009.

While many investors continue to expect substantial rate hikes to stave off inflationary pressures, we believe rate hikes alone are unlikely to solve the problem. In fact, much of the early inflationary pressures are coming from food and fuel price gains, spurred by poor crop harvests or Middle East supply concerns. Hiking interest rates is a very poor policy response to dealing with supply shocks and there are better tools to address the inflationary impulses they generate. Further, the demand for food is fairly price inelastic.

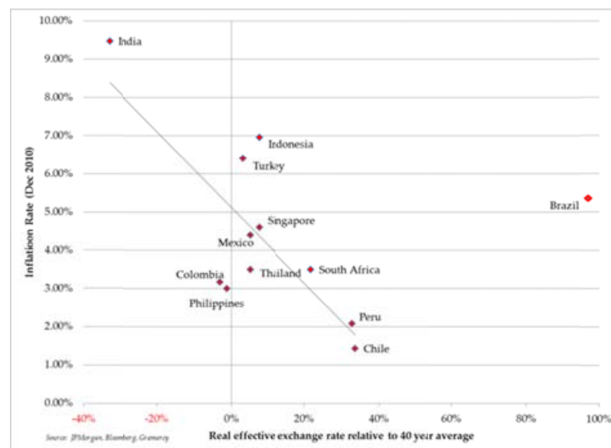
For these reasons, we believe that many emerging nations will seek to offset inflationary pressures by strengthening their currencies. This has two distinct benefits: (1) it reduces the local currency cost of imported food and fuel and (2) it reduces the cost of any subsidies paid on food and fuel, lowering the budget deficit which will further dampen inflationary pressures.

Table 2: Change in Real Interest Rates Dec. 2010 YoY

Nation	Δ Interest Rates	Δ Inflation Rates	Inception Date Current Rate Cycle	Last Change in Rates
China	0.50%	2.70%	Dec '10	Hike 25 bps
India	1.50%	-5.50%	Mar '10	Hike 25 bps
Malaysia	0.75%	1.60%	Mar '10	Hike 25 bps
South Korea	0.50%	0.70%	Jul '10	Hike 25 bps
Taiwan	0.38%	1.47%	Jun '10	Hike 12.5 bps
Czech	-0.25%	1.30%	Aug '08	Cut 25 bps
Hungary	-0.50%	-0.90%	Nov '10	Hike 25 bps
Poland	0.00%	-0.40%	Jan '11	Hike 25 bps
Russia	-1.00%	0.00%	Feb '11	Hike 25 bps
Turkey	0.00%	-0.13%	Nov '08	Cut 25 bps
Argentina	0.00%	3.20%	Jul '09	Cut 25 bps
Brazil	2.00%	1.60%	Apr '10	Hike 50 bps
Chile	2.75%	-0.14%	Jun '10	Hike 25 bps
Colombia	-0.50%	1.17%	Feb '11	Hike 25 bps
Mexico	0.00%	0.83%	Jan '09	Cut 25 bps
Israel	0.75%	-1.20%	Aug '09	Hike 25 bps
Saudi Arabia	0.00%	1.18%	Oct '08	Cut 25 bps
South Africa	-1.50%	-2.80%	Dec '08	Cut 50 bps
Average	**0.30%**	**0.26%**		

There is some evidence that nations that have allowed their currencies to trade stronger are benefiting from lower rates of inflation. Chart 1 on the following page shows the rate of inflation compared to the real effective exchange rate's deviation from a 40 year average for a selection of emerging nations. There does appear to be a modestly positive relationship between stronger currencies and lower inflation. The main outlier is Brazil, which has perhaps the strongest currency in EM and yet has persistently high rates of inflation. Given the recent government moves to reduce spending and rein in the BNDES loan book, perhaps by the end of 2011 this chart will have Brazil in a different spot.

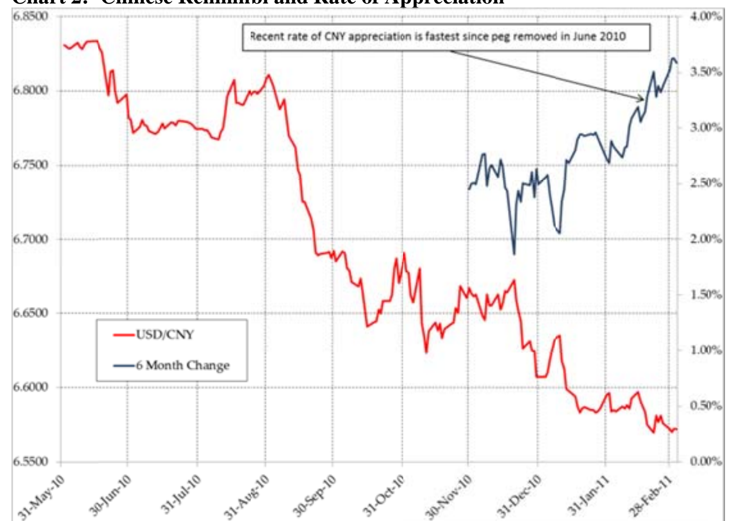
Chart 1: Historical Currency Relative Valuation vs. Inflation Rate



Last year, Brazilian finance minister Mantega characterized global monetary tensions as a "currency war." We have characterized his comments as true but misleading. Most market participants assumed the "combatants" to be the United States vs. the rest of the world. In fact, we believe the real war is between China and the other emerging nations. The others were holding the line on currency appreciation until China made a move. Market participants assumed that the token 4% move allowed in the Chinese yuan had not been enough to prompt other emerging nations to follow suit. However, the rate at which the Chinese currency is strengthening has begun to accelerate (See Chart 2) and more importantly, this time other emerging nations are allowing faster moves towards currency appreciation in order to get in front of the inflation curve.

We expect this to continue during the balance of 2011, and in the macro space we currently expect long EM currency positions to outperform trades betting on higher interest rates. For EM local currency sovereign debt, strengthening currencies are obviously positive, as currency appreciation can drive total returns from a dollar perspective. For EM sovereign dollar debt, this should also be beneficial as countries with significant dollar debt stocks will see their credit metrics improve. For EM equities, the story may be more mixed; while those securities may attract interest from international investors seeking currency exposure, export oriented companies may suffer from decreasing competitiveness. In corporate bonds, issuers will benefit from stronger currencies in terms of dollar debt service capacity, but again there may be competitive pressures on export-oriented companies.

Chart 2: Chinese Renminbi and Rate of Appreciation



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