NEW MINERVA REPORT

Inflation Revisted

Last month we reported how Crispin Odey thought inflation was already unleashed, and the World's central bankers were too late to bring it under control. We have some sympathy with his views. However, Crispin also said he is often early in his predictions. We think his inflation prediction is early, because the US economy is showing signs of slowing down. As reported on the front page, initial estimates show second quarter US growth at 2.5%, caused mainly by the slowdown in consumer spending. The pressure on the consumer is not going to go away quickly. The number of existing homes for sale represents 6.6 months of sales. That is the highest level since July 1997. The increase in house prices has fallen to 1% year on year, compared to 11% back in January. Equally important in the GDP data was the fact that Corporate US does not seem to want to take up the baton from the consumer. Business investment in equipment and software fell in the quarter. It hasn't done that for over three years.

There are two things that will trigger an inflation pick-up: firstly an increase in wage growth, and secondly a change in China from being an exporter of deflation to an exporter of inflation. Because of the entry of China, India and the Ex-soviet union countries into the global economy, there has been a huge increase in the number of potential workers in the global economy. This increase in supply has meant that pressure on wages has been downwards. As a result, company profits as a percentage of GDP are at record levels. In the US, the largest companies are seeing double digit percentage profit increases for the twelfth quarter in a row. But there are already anecdotal signs that changes are afoot. We were talking to the CEO of a large UK company, which has a big call centre. He had been looking into having a call centre in India. He had found that wages had risen by 25% in Indian call centre staff in the last year. He decided to forget about India, as the costs of training, and the negative impact it would have on some customers was not worth the change. Wages in China are also on the rise, up over 13% in the last year. The minimum wage has also gone up. In the Guangdong province, the minimum wage has just gone up 17.8%. Although these are from very low starting levels, it is still an indication of the changes afoot. The final piece in the jigsaw will be when the millions of producing individuals start to be consumers. As the wage levels lift, so too will the demand by those earning those wages. We are already seeing this in some of the largest Chinese cities. Luxury goods have been the first target of the newly rich. This will fan out, as more workers move into a consuming middle class. At the moment Chinese inflation is at 1.5%. China's financial system has always been bad at allocating capital, favouring 'safe' investments that have the best connections to the government. This has created excess capacity in many areas. Eventually unprofitable excess production will be closed down, increasing the upward pressure on prices. Finally, we have recently heard both Wen Jiabao the Chinese Prime minister, and Hu Jintao the President, talk about concerns over the growing trade surplus. If this leads to a pick-up in the pace of exchange rate appreciation for the renminbi, that too will have the effect of pushing up prices. These are all long term secular changes. The US slowdown, coupled with the still excess liquidity in the Chinese economy, which is being spent to increase capacity, should offset the upward inflationary pressures described above. But the upward pressure on prices will not be held back forever. The Chinese economy is growing at 11.3%. The Chinese government will do all in its power to ensure the 2008 Olympics are successful. Economic growth will be maintained to ensure no unrest prior to the games. They will do their utmost to make sure that no economic policy changes will endanger their vision.

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