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REMEMBERING THE FUTURE
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FOOD FOR THOUGHT: GLOBAL FOOD INFLATION AND ITS RAMIFICATIONS

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Introduction

For the second time in the past few years the price of food is making headlines across the globe and deservedly so. Corn has risen 61% in the last year. The prices of soybeans and wheat have both surged over 40% in that same time period. Warnings, declarations, and intense attention has been paid to the topic of food inflation over the past several months from a variety of sources. The UN has warned that the world faces a potential "food price shock." The Financial Times has a dedicated analysis on its website taking an in-depth look at global food markets. Protests have rocked the streets in poor corners of the world as people see little being done by their governments to control the rising costs of their most basic staples.

As far back as the French Revolution, if not longer, history has shown us that the prices of basic food items are a politically sensitive and volatile issue. Concern over food security and the stability of prices has grown so much so that The Economist reported in mid-2010 that sovereign governments were ordering their treasuries to turn to the futures markets in waves in order to secure prices as much as possible.

In both 2008 and 2010 food prices hit record levels (see Figure 1). This month's newsletter will investigate what has been happening in food markets recently and will explain why we believe agricultural investments are a sound and promising sector to invest in during 2011. As usual, we will provide a comprehensive look into explaining our outlook for agribusiness as an investment class, while tying in our forecast for the global economy as a whole.

As food prices keep rising (for reasons discussed below), and as energy prices also keep increasing while economic and financial uncertainty does not subside in the midst of political and social turmoil – especially in the Middle East – the fear is that food inflation (already at double digit levels in China and India) may percolate up in the price chain, something that could have significant negative consequences for valuations of assets worldwide.

Figure 1: FOA (Food & Agricultural Organization) Price Index

How We Got Here: Basic Demand and Supply

The current episode of rising food prices that is gripping the world is indeed experiencing some pressure due to shortfalls of supply. For the past several months global weather patterns have significantly affected harvests and export flows, occasionally in mammoth instances. One of the more notorious stories of 2010 related to global food markets came from Russia. Russia witnessed a summer of torrid heat waves with over 700 wildfires breaking out, forcing thousands from their home. The drought forced President Medvedev to ban the exporting of wheat in order to meet domestic demand, stripping the globe of one of its traditionally largest suppliers. In fact, Russia arranged for its neighbor Ukraine to help supply their own domestic market, something that does not often happen. Usually, the two nations combine to supply 30% of the entire world's wheat.

Supply was hit in other parts of the globe as well. The disastrous floods in Pakistan devastated the wheat harvest of the world's 8th largest supplier. Indonesia in mid-January reported substantial crop failures and was forced to remove its protective import duties to quell prices as best they could; South Korea performed similar actions. India and Argentina also imposed export bans to try and secure its own food supplies. The U.S. recently revised its own crop estimates in a downward manner as well.

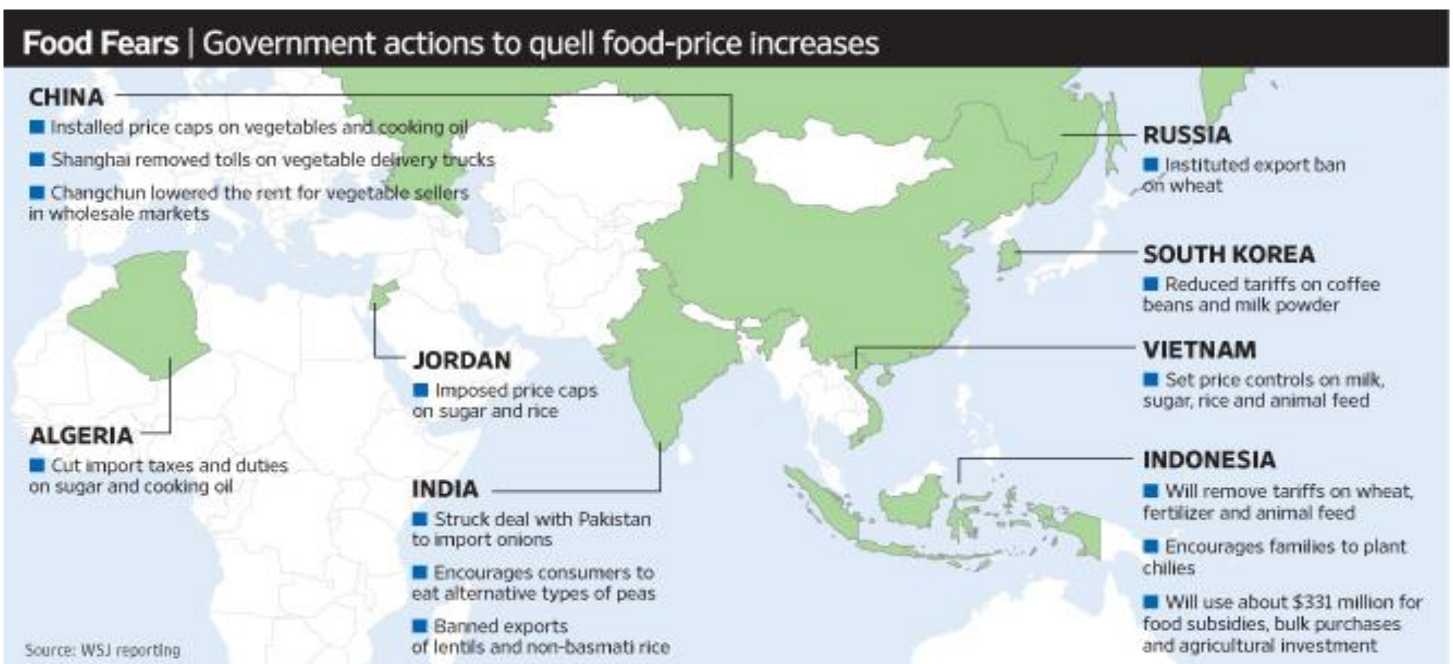
At the same time that global supply was being hit by weather disasters, poor harvests, and lack of investments, global demand was also putting its own pressure on global food prices. As we've highlighted before, economic growth in emerging markets is here to stay and will command a greater piece of the global economic pie going forward. China and India each kept their growth up over 8%, while other economies, like Brazil, Turkey, and Colombia are running along at high rates as well. These countries are all seeing huge numbers of poor people improve their living standards, often times by eating more than one meal a day. More importantly, as these trends continue, residents in these booming countries will start eating higher quality foods, such as meat, which require higher levels of grains than traditional meals exclusively based on cereals. This combination of demand and supply each squeezing prices from opposite ends of the spectrum is having significant repercussions on prices. India (where food inflation is over 18%) is facing domestic hostility due to the explosion in cost of onions, a staple with many dishes, but also due to the fact that it has raised interest rates six times in a year. Palm oil has surged 57% in just the past six months in Malaysia. China has had to release immediate stockpiles of key foods and place price ceilings on other goods as its general inflation rate spiked much higher (to 5.1% instead of the expected 3.3%, while food inflation runs at a rate of over 11% annually).

Figure 2: Price of Soybeans ($/metric ton)

Figure 3: Price of Wheat ($/metric ton)

Source: FAO

Figure 4: Government responses to rising food prices



Source: Wall Street Journal

Other Factors to Consider

One of the most frustrating experiences in analyzing economics is the widespread ignorance and lack of context in which events are often cast. A layman's example: a heavy winter coat on a January night will go for a higher price in Chicago than Miami. The environment makes the market move in a different manner and creates different demand and price structures despite the fact that the coat has identical features in both cities or that it's a winter month in both locations. There perhaps isn't a sector that falls under such a plague of poor contextual analysis more than commodities. When oil prices fluctuate people restrict their analysis to supply and demand curves rather than looking at the bigger economic picture. Much of the analysis directed towards food trends has fallen under the same trap. Most insight into the current rise in food prices resort to the supply and demand dynamics articulated earlier. Yet this creates an incomplete picture.

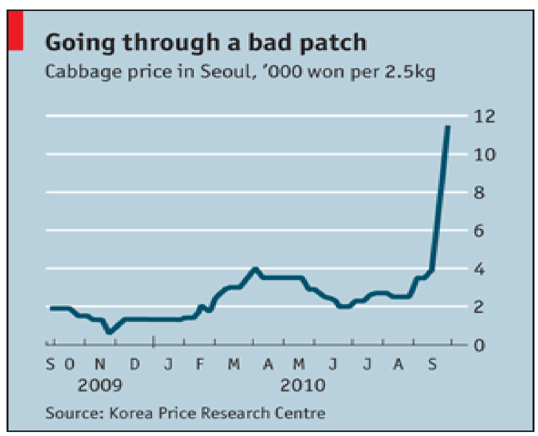
Let's think about the environment surrounding the last run up of food prices in 2008. That was the year in which the global financial crisis was hitting new climaxes every so often. The giants of investment banking around the world were going under, reorganizing their operations, or adjusting their legal standing so as to buffer up their balance sheets. Bear Stearns and Lehman Brothers left the scene. Emergency lending facilities were opened up at the Fed, while also accepting lower grade collateral. People generally fear things they didn't understand; financial chaos isn't an everyday thing. Thus, in the midst of such a chaotic environment "exotic" instruments that banks were dependent upon dropped in value, the equities markets turned sour, and investors put their faith and funds into something they understood: commodities, such as gold, silver, and agriculture. People and institutions understand commodities. There is an inherent and tangible value in wheat, corn, metals, and other raw materials. After all, people will always need food. The same can't be said of a mortgage-backed security or of the derivatives market.

A similar, comprehensive approach of the general economic landscape is needed to explain the rise in food prices. While in 2008 uncertainty swarmed Wall St. and other giant financial institutions around the globe, 2010 and 2011 are faced with another paradigm-shattering foreground: sovereign risks, unfunded liabilities, and the new silk road. The world has seen governments default on its creditors before; Argentina in 2001 is a prime example. But the magnitude and scope of sovereign risks in 2011 isn't something this generation has ever seen. 2010 was riddled with legitimate concerns about the end of the Euro zone, the second largest economic entity in the world. Countries like Greece, Ireland, Spain, and Portugal are more developed than those countries that have had trouble with paying back their debts in the past. In addition, the longer Europe remains haggled with debt and austerity, the more America is left without its largest trading partner. From the American perspective, the economic recovery is like trying to ward off infections growing at different points in the body and spreading at variable rates. Curing one point still leaves you sick.

The other edge of the sword in 2010 has been the sluggishness of growth in the developed world. Growth for the U.S. economy has been anemic. Unemployment figures have barely moved as well. Cheap money and credit in the U.S., combined with few opportunities at high returns domestically, has encouraged money to flow outside the country. The second round of quantitative easing has caused additional unease about the outlook for the American economy and a return to any semblance of normalcy.

These ingredients of uncertainty prompt traditional strategies of hedging and diversification into commodities markets, such as agriculture and energy. Just like in 2008 investors are turning more towards life's basic materials, whose purpose is productive, rather than chasing paper. Hence, the figure below while certainly reflects demand and supply conditions, it too has a subliminal line where the agribusiness sector becomes a magnet of investment funds.

<u>Figure 5: Cabbage price in Seoul, South Korea</u>



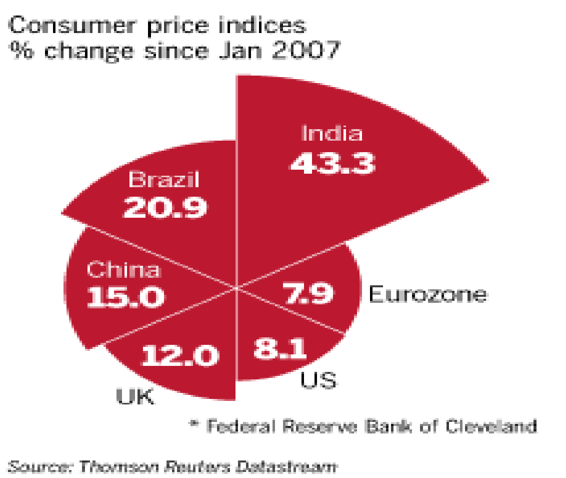
<u>**Consequences of Rising Food Prices**</u>

So what are the consequences of rising food prices? Could this episode of food inflation simply be a cyclical phenomenon that will pass?

Starting with the latter, we would say that the current period of rising food prices is more likely to have "secondary effects" compared to 2008. For one, global demand is much stronger today than it was three years ago. The U.S. is expected to post much more robust growth in 2011 compared to 2008, while economic growth is also stronger in many parts of the developing world, such as Brazil. For governments to scramble to secure food at a stable rate while their economies are expanding, implies both the severity of price rises as well as a fear of political instability. Regarding the latter, we would not be surprised if the unrest in Tunisia, Egypt, Yemen, Albania, Algeria, etc. turns out to be the seeds of destruction for these authoritative regimes, that could be compared to what we saw in the former Eastern block of countries between November 1989 and December 1991.

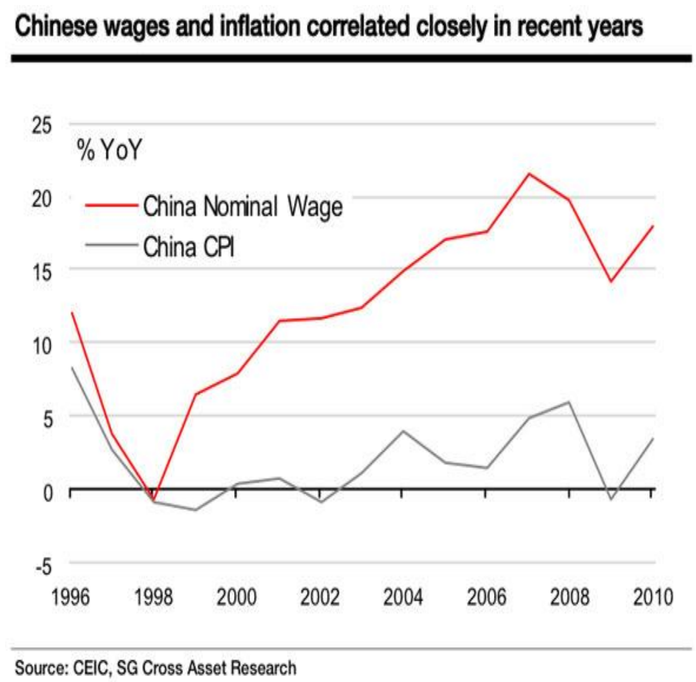
Yet a stronger case for the enduring nature of higher prices can be made if we examine the first question raised: the consequences of rising food prices.

Figure 6: Consumer Price Changes %



We believe that the rising prices that are gripping the food markets will not restrain themselves to just that sector. In realizing the increased burden of a necessity such as food, households and companies will begin to price their own services accordingly. Specifically, labor and salary workers, in order to compensate and adjust for the enhanced difficulty of feeding their families, will demand higher wages from their employers. This relationship has ample historical precedent as Figure 7 demonstrates in the case of China. Earlier in January Beijing announced a remarkable 21% increase in the city's minimum wage. Guandong, China's largest provincial economy, raised its minimum wage by 18%-26%.

Figure 7: Relationship of Chinese Wages and Inflation



As a consequence, many, if not most employers, will in turn pass on these rising costs of labor on to their consumers in the form of higher prices for other goods. Thus, wages will serve as a vital link between the often separated "core" inflation statistics and more traditional and comprehensive measures of price changes. A graph from The Economist demonstrates there is some plausibility to this theory and blooming evidence.

Figure 8: CPI Inflation by Component

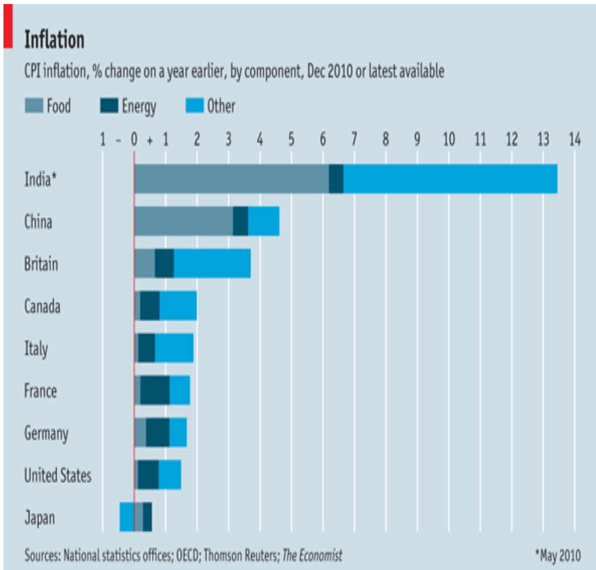


Figure 9: German Wholesale Prices

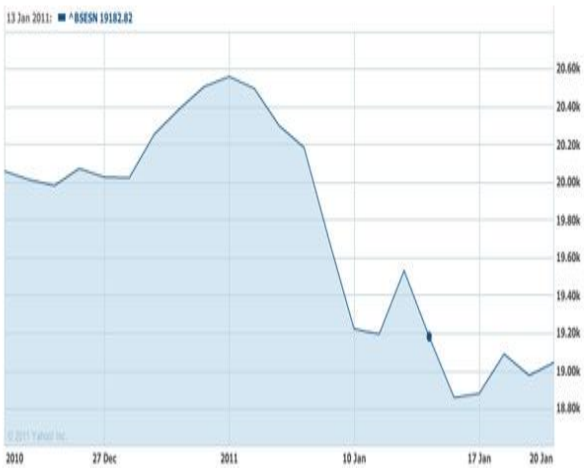
If these trends continue (even in Germany food inflation exceeded 5% last December, as figure 9 below shows) then, general price inflation will spread throughout the entirety of economies as opposed to just remaining in one specific sector. If this plausible inflationary scenario is viewed in combination with the extraordinary monetary measures taken (from special lending facilities, to central banks' swaps, to quantitative easing to name just a few), then the percolating inflationary pressures could have truly devastating effects and it is these "secondary effects" that worry policymakers.

As the Wall St. Journal reported on January 21st, Jean Claude-Trichet, President of the European Central Bank, commented that if food and commodity prices continue to surge, then inflation could rise across the board (in terms of wholesale goods and wages) and could prompt the ECB to raise interest rates later this year. People often forget that in 2008 (in the midst of the financial crisis) the ECB did just that, raised interest rates to combat rising prices.

Some parts of the world have seen governments turn to financial mechanisms to quell rising prices. South Korea's Central Bank raised its key interest rate for the second time in three months to combat rising food and energy prices. The government also announced initiatives to help people pay for food, gasoline, and public utilities. China has raised its required reserve ratio on multiple occasions although reports affirming inflationary pressures suggest the authorities are behind the curve in the world's second largest economy. Bangladesh has tried to place limits on the size of orders traders can place. There's good reason to be concerned about inflation: it destroys incomes and asset values, and diminishes purchasing power.

Look at what has happened to equities markets across the globe due to inflation fears. Investors in India (see also figure 10 below) pulled out $1 billion in a span of twelve trading sessions due to fears of inflation. The stock market in Bangladesh has plummeted by 27% in just a few weeks for the same reason. Thailand, Indonesia, and the Philippines have also seen their markets rocked by inflationary fears.

Figure 10: Bombay Stock Exchange Over 12 Trading Sessions



Equities aren't the only market that suffers under severe inflationary scenarios. Bond markets are sure to suffer. Bill Gross, a well-known bond manager at Pimco (the largest bond institutional investor in the world), explained the irrationality of being a bond holder to the Financial Times: "Why would you want to be a bondholder with bond yields so low and that sort of inflationary trend… If CPI continues above 3 per cent in the UK and 2 per cent in the US, then we are accepting negative real interest rates and that is not an attractive investment." Moreover, as nations like China, South Korea have shown - and as Mr. Trichet has hinted - one of the primary tools to combat price pressures is to raise interest rates. Bond prices of course would tumble in such an act, destroying the investments many have made, and possibly starting the bust in the bond markets bubble. Moreover, raising interest rates threatens growth prospects across much of the globe, especially those areas which are having trouble to grow already (Europe).

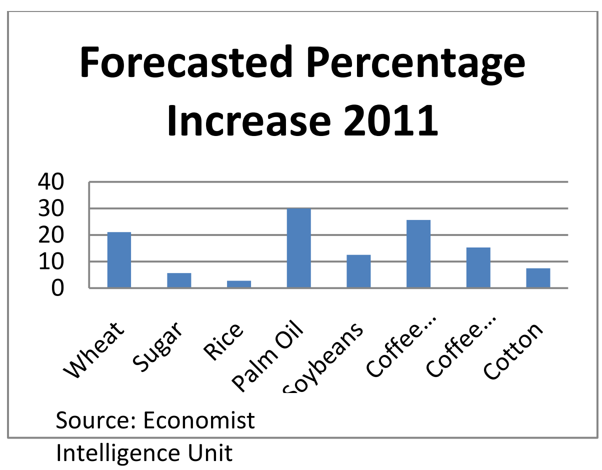
Businesses and corporations also stand to suffer from these circumstances. Higher interest rates, of course, make credit markets tighter and more costly. But higher interest rates also diminish investment opportunities. In order to make investments under an environment of high interest rates, higher returns are demanded. The market of opportunities to make high returns isn't limitless. People would rather turn to risk free forms of investments, whose returns should go up if interest rates are increased.

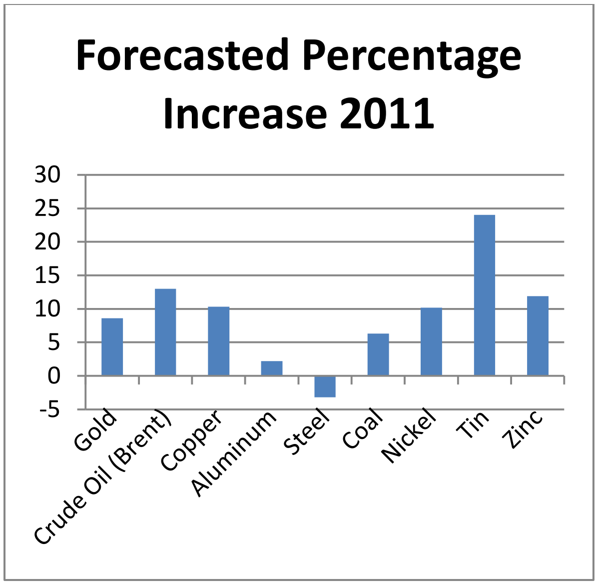
However, there is a positive note in the above scenario too. Higher inflation reduces the real debt since the latter is paid back with inflated dollars. In a more cynical sense, that might be a way out of the unsustainable levels of accumulated debt and of all those unfunded liabilities.

Epilogue: Where to Turn

Given the above analysis and borrowing also from Jim Rogers' views revealed in the Financial Times, regarding his opinions on "real assets", we would say that for the foreseeable future and given inflationary expectation as shown below, the agribusiness and base metal sectors seem to be a rational place to park some cash.

Figure 11: Commodity Price Forecasts





A recent survey published by Northern Trust found that 62% of investors expect inflation to increase over the next six months, an increase of nine percentage points from the last time the survey was taken. Commodities tend to do well under scenarios of inflationary pressure. As Figure 11 points out, the Economist's Intelligence Unit (EIU) forecasts the commodities class to do quite well in the upcoming year. Their value is tangible, inherent, clear, and they are goods that are always needed as we explained earlier. It's an asset that has stood the test of time and a group that people are comfortable holding on to. The EIU has also increased the risk and severity of danger that the global economy faces sovereign defaults, asset bubbles bursting, and protectionism in the form of currency wars. In other words, and like we explained earlier, the economic landscape will continue to suggest an uncertain and wild future. The need for familiarity and transparency of value will continue to reign in 2011 and commodities are prime to gain.

Ode to hard assets!