Aureus Asset Management, LLC
Investment Perspectives
January 2011

Rising Prices: Is Inflation a Threat Once Again?

Introduction

From Argentina to India to China, consumer price indices (CPI) outside the US are rising rapidly. Other parts of the developed world, including the US, still report nearly flat consumer prices. Low interest rates globally and mixed growth prospects make inflation a particularly important variable for different asset classes and specific companies.

The following summarizes our research and observations regarding inflation and possible investment implications for portfolios.

I.

Analyzing the composition of CPI between countries and regions provides a framework for translating today's inflation into investment strategy. A comparison between the US and China is illustrative and significant as much of global financial market performance is tied to fundamental economic conditions in these two countries.

In the US, 42% of the CPI is housing related, and we all know that housing is still experiencing its own deflation in prices, whereas 25% is energy and food related, which are rising rapidly. We would expect somewhat higher CPI in the US as a result of rising commodity prices, although non-commodity based factors in the CPI should mute the overall impact. Yet, many consumers in the US are experiencing higher personal inflation than the reported CPI, as everyday purchases (e.g. food, gas and petroleum based products) impact their pocketbooks. With wages more or less held in check by high unemployment, discretionary consumer spending appears vulnerable.

Food and energy represent about twice the weight of China's CPI relative to the US. As such, prices of grains, vegetables and fruits have an immediate impact on CPI. With prices for many agricultural products having shot up 25% or more since last summer, and oil now over $90 a barrel, acute increases in China's CPI have been observed since last fall.

While investor speculation has played some role in the recent run up in agricultural commodity prices, weather related supply shocks have been primarily responsible. Exacerbating the situation are already tight supplies of many key crops due to bio-fuel mandates imposed over the past decade. In addition, oil prices have risen because of demand, especially from China, India and the rest of the emerging world. Should supply of food normalize in the second half of 2011 as a result of better weather and/or crop yields, we would expect the recent CPI increase in China to abate quickly.

II.

Other important considerations in an analysis of price trends are powerful fundamental deflationary forces currently at work.

Large supplies of labor and manufacturing capacity in the developed world are restraining the full impact of food and energy on CPI. Unemployment rates range from 9% in the US to as much as 20% in parts of Europe. Capacity figures show that US manufacturers are operating at less than 80%, well under the 85% required to support substantive price increases in manufactured goods. Finally, China continues to transition its manufacturing base to higher value added industries (e.g. industrial equipment and transportation infrastructure), thereby putting downward pressure on prices for a growing number of goods.

It is crucial to analyze both the impact on individual countries and industries of commodity price inflation, as well as to judge the offsetting impact of restraint in labor and manufacturing costs.

III.

Our observations translate into investment implications for several key areas.

For equities, margins will be under pressure for companies exposed to commodities including processed food companies, retailers, and certain consumer goods companies. Another force pressuring margins for an increasing number of companies is the progress China has made in higher value added manufacturing sectors, leading to tougher price competition.

Suppliers of commodities should maintain or raise profit margins depending on the level of elasticity of demand for the particular raw material produced. Companies that help manufacturers improve efficiency and reduce costs should be helped as corporations address the prospects of sustained margin pressure with improved logistics and throughput.

From a geographic perspective we expect increases in commodity inflation in the emerging world to continue forcing tighter monetary policy that will, in turn, weigh on their equity markets in the near term. However, when food supply normalizes, investors should once again focus on strong growth prospects in these regions.

For fixed income, fears of future inflation may weigh on prices of high quality Government and corporate bonds. Specialized subsectors of fixed-income such as mortgage-backed securities and actively managed municipal bonds have relatively attractive spreads when compared to Government bonds, and should better resist inflationary pressures.

As investors, we are focused on the companies, sectors, and asset classes best positioned in this environment.

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