

The threat and opportunity of inflation

AT A GLANCE

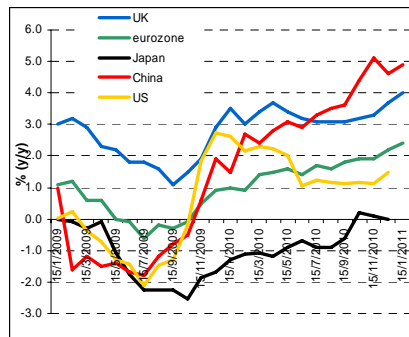
- Inflation is rising globally
- Inflation tends to erode the value of assets and associated cash flows
- It is mainly cost-push factors, particularly food and energy prices, that are driving higher inflation today
- In response to inflation, policy interest rates are either rising or will in the future
- Both inflation and higher interest rates require appropriate actions from investors
- Inflation-linked bonds represent one of the purest anti-inflation strategies
- Exposure to real assets, such as commodities and property can offer good inflation protection
- Within equities, the key thing is to look for companies which have pricing power

With the notable exception of the US, rising inflation is increasingly becoming a headline news story all across the world. Here, we take a look at why inflation matters to investors, the reasons why inflation is becoming more of a concern at the present time, and the actions that central banks are taking to deal with this. Finally, we explore and evaluate the different ways through which investors can position themselves to protect against and even profit from rising inflation.

THE GLOBAL CONTEXT

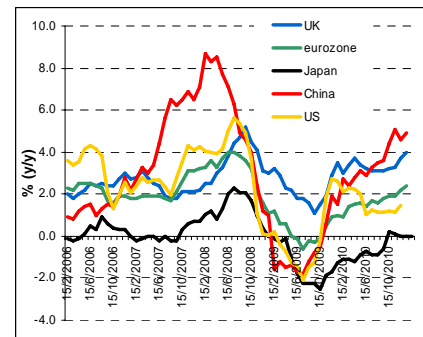
The overall global picture is one of rising and in some cases problematic inflation. This is particularly the case in some of the key emerging markets such as China and India, where inflation is running at around 5% and 8% respectively. In the 17-nation eurozone bloc, inflation rose to 2.4% in January 2011, staying above the ECB's target level for the second successive month. In the UK, more significant pressures are evident with inflation staying above the Bank of England's 2% target for over a year and very recently touching 4%. Aside from the perennially special case of Japan (which remains mired in deflation), the only major exception to the wider global trend is the US, where inflation remains well below 2.0%.

GLOBAL INFLATION: 2-year view



Source: Datastream, 16.02.11

GLOBAL INFLATION: 5-year view



Source: Datastream, 16.02.11

WHY INFLATION MATTERS

Inflation is one of the most important and widely followed economic statistics for any economy. It can erode the value of money, including wages, making people worse off in real terms. When this happens and prices are expected to continue rising in the future, this often leads to demands for higher compensation from employers, potentially giving rise to a 'wage price spiral'. As recent events in Tunisia and Egypt have demonstrated, high inflation can even contribute to periods of serious social unrest. Given this, it is unsurprising that controlling inflation is a paramount economic policy objective across all countries, with many central banks independently empowered by governments to deal with the issue.

From an investor perspective, inflation is almost always a bad thing that demands appropriate protective action. As with wages, inflation tends to erode the value of most assets and any income generated by these assets. Of more short term importance for investors, however, is the interplay of inflation and interest rates; in order to control prices, central banks usually raise interest rates. In doing this, they effectively seek to lower aggregate demand in their economies. As demand for goods and services falls, this can obviously be negative for the companies and the shares of the companies that supply these; both sales and profits become vulnerable in this context. While equity investors worry about the negative demand impact of higher interest rates, bond investors, are affected more directly because higher policy rates tends to push up bond yields, resulting in lower bond prices.

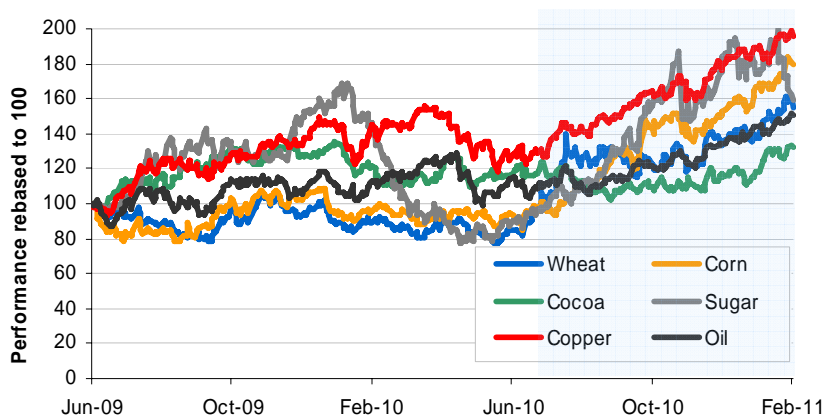
"Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man."

Ronald Reagan, 40th US President (1911-2004)

WHAT IS DRIVING INFLATION TODAY?

Inflation can either be 'demand-pull' or 'cost-push'. The former stems from strong demand, which causes economic spare capacity to be used up, putting upward pressure on various resource prices. The latter stems from higher input prices, such as higher commodity prices, including food and energy prices. At present, the evidence from around the world (see chart below) strongly suggests that it is mainly cost-push factors that are driving up global inflation. Although energy prices have been a key factor, with the oil price recently re-crossing the \$100 per barrel level, the influence of higher food prices has been particularly important. In India, for example, food prices rose by 15% in the year to December 2010. Moreover, the influence of food prices in emerging markets is magnified due to the significantly greater share of food in their consumer prices indices - around 30% in comparison to 13% in developed economies.

COMMODITY PRICE RISES



Source: Datalstream, 15.02.11

"At about \$400 per month, Chinese workers are now three times more expensive than their Indonesian counterparts, and five times as costly as in Vietnam...."

Financial Times, 15 February 2011

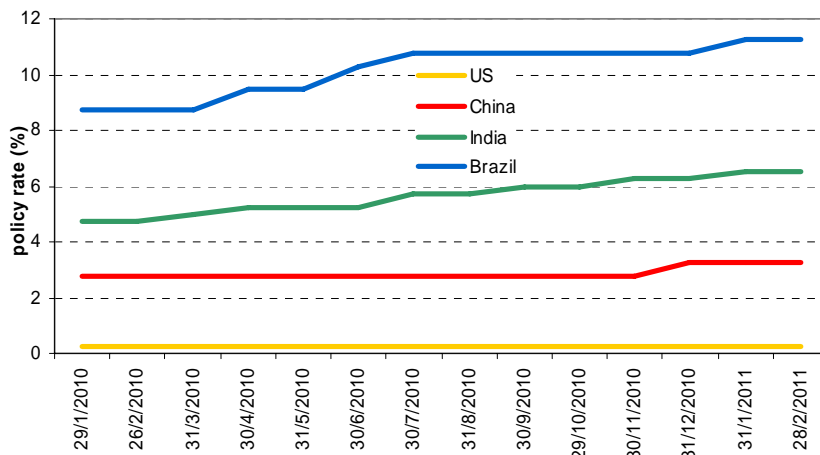
While it is true that global inflation is being driven largely by cost-push factors, in some ways, the distinction with demand-pull inflation can be a misleading one. Indeed, as we know, prices are always determined by the interaction of both demand and supply side factors. For example, one of the main reasons why global oil and copper prices are rising is due to strong demand for these items from China, which has been leading the global economic recovery. On the same subject, it was not so long ago that China, owing to its very cheap labour costs, was described as 'exporting deflation' to the rest of the world. However, as average wages in China inevitably rise, the favourable disinflationary impetus for the rest of the world is also dimming and could even reverse in time. Indeed, anecdotal evidence for this may already be emerging, with low-cost laptop manufacturer Acer recently increasing its prices for the first time in five years.

GLOBAL POLICY RESPONSE

The factors driving inflation are always very important because they strongly influence the response and likely effectiveness of any central bank actions. As noted before, it is largely cost-push factors such as higher commodity prices, including food prices that are pushing up global inflation today. Since higher interest rates work to reduce inflation by reducing demand, their effectiveness in tackling cost-push inflation is usually more limited. Still, this does not necessarily mean that interest rates should not be raised in this situation because cost-push inflation may exist at the same time as demand-pull inflation, or the authorities may be happy to reduce demand because they fear that cost-push inflation will eventually lead to a damaging increase in inflation expectations and demands for high wages.

Today, with inflation rising in most places, the general trend of global policy interest rates is up. The most aggressive action is being taken in emerging markets (the so-called BRIC countries - China, India, Brazil and Russia - have been tightening policy for some time and will continue to tighten further in 2011). While inflation in these countries is being driven in part by interest rate-insensitive commodity prices, tightening is still warranted because of strong demand conditions and because of more limited spare capacity. Even in those instances where rates have not moved, such as the UK and Eurozone, markets expect the next move to be upwards. In the US, the next interest rate move from virtually zero can only be up, but lower inflation should enable the Federal Reserve to keep interest rates lower for longer than most of its global counterparts.

EM POLICY INTEREST RATES v US FEDERAL FUNDS RATE



Source: Datastream, 16.02.11

SHARP DIFFERENCES OF OPINION

While inflation is clearly rising in most cases, it is remarkable that we are seeing an unusually high degree of disagreement about how to deal with it, including, in some cases, within the central banks themselves. Perhaps the best example of this is the UK, where for some time now there has been a three-way split among the members of the Bank of England's Monetary Policy Committee (MPC) between those who wish to keep rates unchanged (the majority), those calling for additional monetary easing and those advocating higher interest rates. This divergence of opinion among policy makers, who after all are looking at exactly the same data, illustrates very well the scope for subjectivity in the assessment of the outlook for inflation and economic growth.

INFLATION PROTECTION STRATEGIES FOR INVESTORS

A number of strategies exist for investors seeking to gain protection against high and rising inflation. All these strategies have a particular mix of pros and cons associated with them. Below we consider some of the main alternatives that are available to investors:

INFLATION-LINKED BONDS - In an environment of rising prices, inflation-linked bonds are one of the most obvious places to invest. These bonds provide protection against inflation by giving investors a coupon interest rate payment, plus the inflation rate in the relevant market, which is usually adjusted every three months. The global market for inflation-linked bonds is large and liquid which allows for immediate and direct hedging against measured inflation. However, a potential problem here can be that measured inflation may not accurately represent actual inflation experienced by individuals, based on their personal spending habits; more importantly, like all bonds, so-called 'linkers' will still be exposed to interest rate or duration risk.

PROPERTY - Property rental costs are reflected in most consumer price indices and therefore contribute to inflation. More importantly, one of the oft-cited benefits of property is that it is a 'hard asset' that is normally contractually able to raise rents.

COMMODITIES - Commodities, including industrial commodities and food, have been the key driver of global inflation in recent years, so it makes good sense to have some exposure to these items as part of a diversified investment strategy. Futures contracts are one way of gaining exposure to these areas. However, these are less suitable for most ordinary investors owing to a range of complicating technical factors. One of the easiest and effective ways for investors to gain exposure to these areas is through investing in relevant commodity stocks. However, as the recent travails of BP have demonstrated, the problem with this approach is that you also gain exposure to company specific risks.

GOLD - Traditionally gold has been seen as a good hedge against inflation. In fact, this depends to a large extent on how long the chosen historical time horizon is. However, as the chart below shows, in the last two years there has been a clear positive correlation between US inflation and gold prices. In addition, as it is priced in US dollars, gold also offers protection against any significant debasement in the value of the US dollar, a risk increased by the very high level of

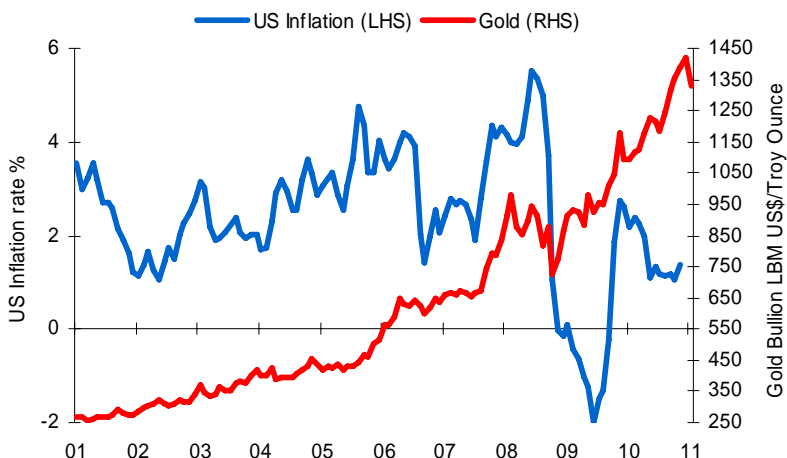
"The purest form of insurance against inflation, and one that has been more out of fashion than other types of hedges, is index-linked government bonds. If the market really starts to believe that the inflation genie is out of the bottle, there will not be enough index-linkers to satisfy demand." Andrew Wells, Portfolio Manager, Fidelity International

"Global real assets can serve as a good hedge against inflationary risks. Selected commodity and real estate companies can be particularly effective in this regard. More generally, in an inflationary environment, I look for companies with good pricing power in their respective markets." Amit Lodha, Portfolio Manager, Fidelity International

money printing which has occurred in recent years in an effort to stimulate the US economy.

EQUITIES- Generally, over the long term, inflationary environments tend to favour growth assets such as equities. However, this needs to be counterbalanced by an assessment of the adverse impact of interest rates which often increase at the same time and which have the effect of lowering demand in an economy. A good strategy for selecting equities is to look for those companies with a proven ability to pass on price rises in their respective markets.

US INFLATION AND GOLD



Source: Datastream, monthly data points. 02-2001 to 02-2011

CONCLUSION

As a result mainly of cost-push factors, especially higher food prices, inflation is becoming a growing area of concern throughout the global economy. While leading emerging markets have been tightening monetary policy for some time already, elevated inflation readings mean that others, including the UK and eurozone, will also soon join this trend. Both higher inflation and higher interest rates are major risk factors that investors should be taking steps to guard against. A range of strategies are possible, including higher allocations to inflation linked bonds, commodities, property and the equities of those companies with a proven ability to raise their prices.



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