

Money Management

Bearing up in 2008

WELCOME to the first edition of *Money Management* for 2008 – a year that promises to be somewhat more challenging for the financial services industry.

While many of the economic commentators appear to be divided about the outlook for the year ahead, there can be no questioning the fact that at least the first six months of this year will be affected by the fall-out from last year's sub-prime meltdown.

After nigh on a decade of easy liquidity, we are witnessing a change that will have serious implications for many investors.

The major banks have seen fit to unilaterally raise interest rates and we have seen major financial institutions forced to make provision for what they acknowledge were poor strategic decisions with respect to debt exposures.

Then, too, there is the question of whether the US economy will be able to resist declining into recession and, if it does fall into recession how that will impact the global economy and, indeed, Australia.

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It is fair to say, however, that for each of the past four years there have been those who have predicted that the double digit returns enjoyed by many investors would come to an end.

Indeed, a search of *Money Management's* archives suggests that since 2004 there have been numerous early January commentators prepared to predict a downturn in markets, not least the bull run enjoyed by Australian equities.

In each of those years, the early January pessimists have been proved wrong.

Australian equities have remained strong, super-annuation returns have remained in double-digits and investors have had every reason to maintain expansive strategies.

But whereas the pessimists got it wrong in 2004, 2005, 2006 and for most of 2007, there is every reason to suggest that they may finally get it right in 2008.

What does this mean for financial planners?

Not a great deal if they have ensured their clients maintain a well-diversified investment portfolio and have been kept fully and appropriately informed.

However, investor psychology is another matter and advisers need to remember that it is now nearly half a decade since the negative returns experienced in 2002-03 and that many of their clients will never have experienced a really bear market.

There are those who are predicting that the financial markets will withstand factors such as the sub-prime and that returns, while somewhat subdued, will remain in positive territory throughout 2008.

It is to be hoped they are right, but it would seem better to err on the side of caution.

– Mike Taylor

POINT OF VIEW

Measuring the impact of agflation

By Tim Hornibrook

THE term 'agflation' refers to the increase in the price of food caused by rising demand for human consumption and its use as an alternative energy resource. Agflation has seen the Food and Agriculture Organisation's global food price index, which summarises agricultural commodity prices, rise 37 per cent year on year to September 2007, stoking inflation fears and putting central bankers on alert.

In China alone, where food consumption accounts for a large portion of its disposable income, interest rates have risen substantially during the past 18 months.

The impact on inflation and interest rates ultimately results in weaker equity prices for investors, including those here in Australia.

As such, agflation is becoming an issue that financial advisers will find difficult to ignore.

First, let's consider how agflation came about.

Many commentators believe that the world is now at the end of the cheap food era and that food will begin to constitute a larger share of every family's budget.

It is clear that the global agricultural market is undergoing structural changes, with increased demand for food, particularly protein, especially from developing countries.

Additional pressure is being exerted as a result of decreasing agricultural land supply and the use of crops as an alternative energy source.

Global economic growth underpins agflation, caused by urbanisation and a rise in disposable incomes in Asia. The growing wealth of developing economies is helping to transform their diets, with per capita beef consumption in China increasing over fourfold since 1990.

Current increases in food prices are a stark contrast to the decades of falling 'real' prices, which were driven by the 'green revolution'.

The 'green revolution' occurred in response to food shortages in the developing world, which led to higher agricultural pro-

ductivity and eventually global overcapacity.

As a result, from the 1960s we experienced three decades of fast growing food supplies and a drop in the 'real' price of food.

At the moment, food represents about 25 per cent of the world's consumer price index (CPI) and makes up an even higher percentage of personal expenses in the developing world.

While in Australia food makes up 18 per cent of our CPI, in China it accounts for 33 per cent and in India 46 per cent.

Now we should consider how this can impact Australian investors and their portfolios. The answer to this lies in inflation and interest rates.

If food prices continue to rise as they have been doing, this will cause continued inflationary pressure.

Any increase in the most expensive item in the developing world's household budgets is likely to lead to a corresponding increase in wages, resulting in significant wage pressure at the cheapest end of the labour market.

Inflationary pressure means higher interest rates, which results in weaker equity prices.

Further to this, higher wages in countries like China mean higher priced manufactured goods for the rest of the world, which could lead to further inflationary pressures and an even greater strain on equities.

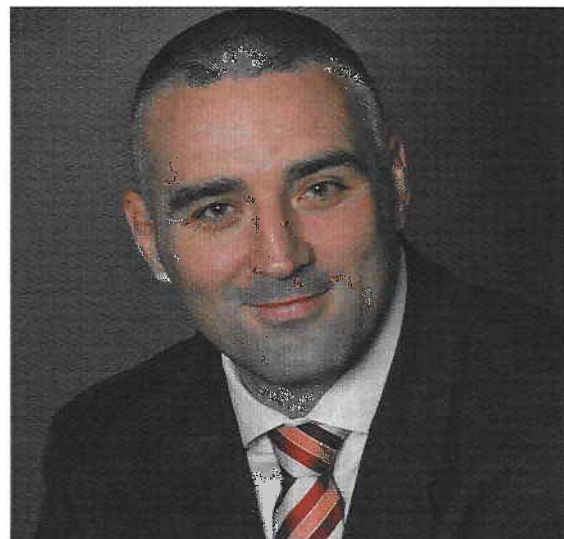
In this environment, finding ways to hedge client portfolios against this risk becomes increasingly important.

Looking at what we can expect from agflation in the future, history has shown that energy and metal prices rarely jump without a corresponding jump in the price of food.

The same theme driving the current 'stronger for longer' base metal cycle is also underpinning a long-term bull market for soft commodities.

While food has lagged in the current cycle, it is expected to be a major winner in the next leg. Let's consider why this is.

Last year was the first year in history that urban



dwellers exceeded those in rural areas.

The industrialisation of the developing BRIC (Brazil, Russia, India, China) economies in particular is leading to higher living standards, meaning that per capita income increases, allowing people to change from diets dominated by grain to eat more sugar, vegetable oils and meats.

Eating more meat means that more grain is used as animal feed, so a shift towards greater meat consumption is multiplied many times over in the grain market.

In addition to this, conditions are being made harder by a decline in global food production subsidies, a decrease in arable land, water scarcity issues and climate change.

However, more important is the significant diversion of agricultural production into the rapidly increasing biofuels industry in Europe, South and North America.

Bio-fuel production is the main reason for the recent dramatic increase in grain prices. Not only does bio-fuel production lead to price increases for corn and sugar, but it also pushes up the prices of other crops as growers increase the production of bio-fuel crops by converting land previously used for other agricultural commodities.

The combination of industrialising BRIC economies causing an increased demand for food, coupled with supply constraints caused by agricultural land becoming scarce and crops being diverted into bio-fuel production, means that farmers will struggle to meet

this increased global demand.

For the first time in decades higher raw material costs for food manufacturers are being passed on as 'real' price increases to consumers.

In this way, factors causing agflationary pressure are leading to structural changes in the demand and supply fundamentals for agriculture.

Like the impact of China and India in hard commodity markets during the past few years, the factors driving agflation will continue to impact global food prices. The difference is that agflation is currently in its early stages and the world has a much greater need for food than it does hard commodities.

Due to its expected impact, agflation is an issue that anyone involved in financial markets will find difficult to miss, not just the central bankers who are becoming increasingly concerned about the potential effects.

For you, as an adviser, agflation presents a risk to all investors' portfolios, so the real question is how you might hedge this risk to provide a level of protection.

One of the ways you might consider doing this is by making an appropriate investment in the sector itself, looking at companies that may be set to benefit from the demand, potentially allowing your clients to profit from increasing agricultural prices while also helping to buffer their portfolios against the flow-on effects of agflation.

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