

Perspectives for Investors in the Middle East and Beyond: Twin Challenges of Inflation and Volatility

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INTRODUCTION

The unrest and volatility that has swept across the Middle East and North Africa from Tunisia to Yemen is not, contrary to popular opinion, just a political phenomenon. It is also a manifestation of inflation hitting many emerging market economies.

As food and energy prices have risen over the last three years, rising price pressure has hit emerging market workers' spending power. Fifty percent of all expenditure among emerging market workers goes on food and energy. Despite the strong top line growth, standards of living have been increasingly squeezed even among the fastest growing emerging markets. A similar mix of political and economic pressures is showing up everywhere across Latin America, China, India and Vietnam, to name a few countries.

Food inflation has a tendency to hit the most vulnerable locations first. The first food riots occurred in Mozambique six months before events unfolded in Tunisia. Most investors dismissed this event if they were aware of it at all. However, it was a symptom of the pressure and sign of things to come. By December, Bangladeshi textile workers began to riot (even after substantial pay hikes) as well. China's leadership began to think about price controls and locked down itinerant worker communities by not allowing workers to leave their neighborhoods after dark unless they had the right paperwork. India is known to have rice riots.

INFLATION FACTORS

Investors have been driven by two themes during the last few years that are proving to be wrong. The first theme is that deflation is the biggest risk and inflation is either dead or a much-wanted luxury in a deflationary world. The second theme is that industrialized countries had no hope of recovery, let alone decent growth, prompting institutions and investors worldwide to invest the bulk of their risk capital into emerging markets.

As it turns out, inflation is ripping through the emerging markets and now beginning to cross over into the industrialized world. The recovery of profits and pricing power is well underway in the US. How did this happen?

The Global Financial Crisis created the first supply-side shock since the oil crisis in 1974. Many of the marginal additional suppliers of natural resources (most things we extract from the ground) went out of business. Agriculture, mining and energy extraction are all capital intensive undertakings. When banks stopped lending, farmers in most parts of the world stopped buying seeds. Without working capital from banks, mining operations were forced to shut down. Even large firms in these sectors found themselves on the brink of bankruptcy. So, naturally, those firms that did survive began to raise their prices. The lessened competition permitted it and the lack of access to capital demanded it.

Governments from the US to China exacerbated the problem by reducing interest rates to effectively zero and expanding fiscal policy beyond all previously known

boundaries. They did this, for the first time in history, simultaneously. The world was flooded with free money. Free money invites speculators to place capital in the riskiest assets – after all, it is free so it is logical to punt it toward the highest possible return.

In a world where policymakers are trying to create as much inflation as possible to defeat deflation, paper financial assets initially rise. Eventually, investors worry and realize that each paper financial asset must be worth less when so much supply of paper financial assets, whether currencies or bonds, is being printed. As a result, investors began to turn toward hard assets such as gold whose price rose 29% in the last 12 months and 64% in the last two years.

More importantly, every hedge fund, pension fund and large asset manager including sovereign wealth funds, began to acquire what is now called “The Breakfast Complex”: cereals, grains, orange juice and citrus, meat and potatoes. However, they did not invest in farmlands or farming operations as much as in the price of commodities grown there. Instead, they bought financial assets such as ETFs, commodity indices and futures linked to agricultural products. For example, in the last twelve months through March 2011, the S&P GSCI Agriculture Index climbed 62 percent even though it swung wildly.

This pushed prices up further but without making capital available to actual farmers and miners. While prices rose, capacity did not expand. After all, how can you expand capacity in the absence of bank lending? Why would you increase production in a world where all the important central banks are declaring that the deflation problem is so severe that more free money is needed to keep growth intact? Investors forget that it takes years to increase farm and mining

production even if the owners are committed to that outcome.

So, the official national food inflation rate in, for example, India is 16.5%. But in fact the price of staple food items has risen higher: chili has risen by 300% in a year in India and 500% in Indonesia. Turmeric is up 150%, onions over 100%. The numbers are worse in urban areas. This is true across all emerging markets.

From the supply side in the United States, record corn acreage of 37.1 million hectares (the highest since 2007) will not be enough to meet consumption, animal feed and biofuel demand according to a Bloomberg News survey. On the demand side, rising input prices combined with weak consumer spending has forced food companies to reduce package sizes while keeping the sticker price constant. This is surreptitious form of inflation.

RISK AND VOLATILITY

It is a mistake to think that the volatility story begins and ends with events in the Middle East. Concerns over US municipal finances, European periphery debt, bank balance sheet weakness and natural calamities (see Japan) have also reminded investors that risk appears in every market and affects every asset class. It is also a mistake to ignore the consequences of food and energy inflation.

High inflation tests the social fabric of a country and exposes other kinds of tensions and long-standing grievances. The pressure quickly reveals the fragilities in society. For example, Egypt’s political balance of power rested (and still rests) to some extent on a subsidized bread price. When wheat prices spiked, the politics collapsed.

As in many industrialized and emerging countries, inflation and difficult economic choices have bred political and market volatility for investors.

OPPORTUNITIES...

Many investors, especially in the West, are frightened and want to exit emerging markets which have become “too hard”. This is a mistake. Instead, investors need to discern between the winners and losers by doing their homework.

Depending on their risk appetite and tolerance for volatility, investors can choose to dial up or dial down exposure to risky countries and assets versus safer ones.

...IN MENA

For example, among the oil and food importers in the Middle East, it seems more likely that Tunisia will eventually emerge as a strong growth story over time while Egypt will continue to see a challenging road ahead. Tunisia has the benefit of 30 years of mandatory universal education and a population that aspires to be European. They want to be part of the world economy. Tunisia’s citizens will probably opt for a future that permits much greater freedom for entrepreneurs and growth.

Egypt, in contrast, has more complex power structures combined with conflicting social pressures that seem not as easy to resolve with a common commitment to a market-friendly outcome. Egyptian stocks lost about one-third of their value from peak to trough since January’s events and, although have made modest gains recently, comments from business leaders points to a long slow economic recuperation ahead.

On the other hand, Gulf-based oil exporters have fared much better. It may be argued that exposure to Qatar and Abu Dhabi has provided relative safety across regional and even global markets and discerning international investors have taken note. As sovereign issuers, both benefit from political stability, oil and gas reserves, budget surpluses and manageable debt ratios despite heavy infrastructure expenditures.

For example, Qatar and Abu Dhabi sovereign CDS spreads increased by 20 and 10 bps, respectively, since the start of the North African political crisis earlier this year. In contrast, Egypt’s CDS jumped over 200 bps before settling at a net rise of 92 bps; Bahrain’s increased by 140 bps.

In fact, at a CDS spread of 110 bps in March 2011, the credit markets view both Qatar and Abu Dhabi more similarly to South Korea and Brazil and much safer than Italy, Belgium, Russia, Turkey and Poland.

No one is better placed to judge the social fabric question in the region than the locals. This is a historic opportunity for Middle Eastern investors to pick and choose the most likely outcomes with a higher degree of success than any outsider.

...IN EMERGING MARKETS

Across other emerging markets, investors should be looking for signs of inflation pressure in the form of protests and price controls. With SWFs accelerating their efforts to buy, own or control food and energy production, there are further constraints on supply available to the market which pushes up the prices further. Civil unrest naturally tends to reduce extraction as farmers and miners become more cautious. So, the supply-side problem is set to worsen.

Based on past historical patterns, civil unrest may unlikely be contained within countries. Investors should look to signs that conflicts could break out between states and not just within them. One could imagine a scenario where governments try to control scarce and contested resources or seek to distract their citizens from protest by building up a foreign opponent.

...IN DEVELOPED MARKETS

Meanwhile, the relative stability in the industrialized world combined with the intense focus on the restoration of profitability means that investors should pay close attention to investment opportunities in the advanced markets.

Manufacturing has been moving from China back to the US over the last couple of years as increased costs in China and the reduced costs in the US have evened out the relative advantages for manufacturing.

Of course, the debt burden continues to bear down on growth but Western governments are moving ever closer to defaulting on that debt burden, thus opening the way for more growth and inflation. In Western Europe debt “haircuts” are already built into market prices.

In the US, the default through inflation seems well underway as the US authorities offer every excuse possible for ignoring inflation pressures that are slowly appearing in the data.

CONCLUSION

The issues we raise here should help investors think about investment opportunities and risks in the Middle East more accurately. Inflation and volatility have been investors’ constant companions posing challenges for asset allocation.

Commodities are on an upward trend but, as investors start to fear China and India slowing growth with interest rate hikes, we would expect price volatility to increase. Defaults in Western Europe and difficulties with local US municipal finances will further damage confidence in growth.

After years of focusing on top line growth, it is now time for investors to pay attention to bottom line price pressures. As we outlined in our Fall 2010 article, “Global Investment Themes for the Middle East”, the better investments are in those operating businesses that generate genuine, unimpaired cash flow.

Increasingly, these will be hard assets including mining, manufacturing bottlenecks and brand-driven operations that can manage margins effectively through purchase power or supplier dominance.

Thank you.

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Amwal Asset Management is the asset management arm of Doha, Qatar-based Amwal Q.S.C., an independent financial services firm founded in 1997. Regulated by the Qatar Central Bank, Amwal advises and manages portfolios for investors focused on the greater Middle East region.

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