

Mutual Success

Your Fund of Information



Inflation – The Invisible Thief!

In Economics 101, inflation is defined as “too much money chasing after too few goods, causing the price of goods to rise.” For example, if there is a supply disruption in oil due to a civil war in an oil producing country, the market price of oil is likely to rise. At the same time, if the demand for oil increases as a result of an increase in global oil consumption, the price of oil is also likely to rise. An increasing demand coupled with limited supply will definitely drive the oil price higher, resulting in oil price inflation.

We can relate to inflation’s insidious effect when we hear others say “when I had \$20,000 50 years ago, it was a lot of money, but now, it does not seem like a lot of money at all!” The main culprit is inflation – the invisible thief. If we assume an annual inflation rate of 5% for the last 50 years, the present value

of the same \$20,000 is in fact \$229,347 today. This means that having \$20,000 in your pocket 50 years ago is the same as having \$229,347 in your pocket today. No wonder 50 years ago, \$20,000 seemed like a lot of money! Over time, capital erosion caused by inflation is inevitably huge.

Economists use various inflation terminologies. There are a number of different ways in which inflation exerts an influence upon our economy. These include: deflation (large decrease), disinflation (slight decrease), inflation (normal increase), stagflation (large decrease), or anywhere in between. Fortunately, periods of deflation and stagflation are normally shorter compared to periods of normal inflation. The best time for economic growth is when inflation is low, stable, and non-threatening to growth.

Central banks in many countries try to maintain inflation in an acceptable range. The Central Bank of Canada’s target inflation range is between 1 – 3 %.

The inflation rate measured by most central banks is Core Consumer Price Index (CPI). The reason central banks or governments use Core CPI (which is usually less than headline CPI) is to have a more stable measure to base their long term planning and policy decisions on. Another inflation gauge is Headline CPI, which is the aggregate price of a broad basket of goods such as energy, food, housing, transportation, medical care, recreation, education, and communications etc. Core CPI, on the other hand, excludes items that have volatile prices such as energy, food, and housing. Because the government uses Core CPI

DISCLAIMER: E&OE: Investment Fund values change frequently and past performance is not indicative of future performance. No guarantee is given or implied and there is risk of loss as well as the opportunity for gain when investing in mutual funds.

Inflation – The Invisible Thief!

instead of Headline CPI, the government's definition of inflation underestimates the real rate of inflation. As consumers, we feel the impact of inflation immediately (e.g. price of gasoline) and we come to accept the increased prices. We get used to the higher prices as our inflation psychology changes and we come to accept even higher prices.

The current economic environment is one where inflation could have a significant impact on the investment environment. We are living at a time when our demands on the planet's depleting resources are ever increasing. Recently, the price of agricultural items such as wheat has appreciated considerably, a result of supply not being able to keep up with increasing demand. A few countries have even banned the export of rice. In short, we are running out of resources including cheap oil and land to expand our food production. Moreover, large and populous emerging markets such as Brazil, Russia, India, and China (BRIC) have a growing demand for resources created by their growing middle class that demand the consumeristic lifestyle.

In the past, there has been an implicit assumption that inflation has a built in mechanism of self correction. For example, higher prices will lead to lower demand, which in turn will lower prices.

Unfortunately, recent anecdotal evidence suggests that the current inflationary phenomenon is more non-linear and abnormal; hence, traditional return to mean may no longer hold. A good example is the price of crude oil. It was expected to return to the \$50 range for a few years now; nevertheless, the oil price continues to reach even higher highs, currently at \$120 a barrel. Similarly, the CRB-index (an index that measures the aggregate price of commodities) continues to break new highs. Prices are more persistent than ever on the up side and a return to "normality" is not expected anytime soon. In fact, the rising cost of crude oil will ultimately intensify the inflation effect as price transmission will soon be passed through in the form of higher airfares, delivery charge, and a variety of costs to businesses.

Interestingly, different parts of the world are currently experiencing inflation differently (see Figure 1). Globally, inflation pressures have intensified. Countries that have budget surpluses, such as China, Singapore, and South Korea can afford to subsidize the high cost of goods or let their currencies rise. In contrast, Asian countries that are running budget deficits are more constrained and are not cutting interest rates to stimulate the economy as they cope with higher inflation. The U.S., Canada, and the U.K. are currently cutting interest rates while ignoring the risk of inflation.

Their goal is to fight slower growth from the spillover of the credit crisis. The weaker growth prospects prompted these central banks to cut interest rates, but once growth starts to rise, these countries will too join in the battle to fight inflation. Nevertheless, Europe's European Central Bank (ECB) is currently more concerned about inflation than growth. The ECB currently pursue a path that deviates from the U.S. Federal reserve bank in terms of interest rate monetary policy.

Figure 1. Inflation Rate in Different Countries

Country	Latest Inflation Figure
China	8.30%
India	7.00%
Australia	4.25%
Singapore	6.70%
Malaysia	2.80%
Vietnam	20.00%
Philippines	6.40%
Indonesia	8.17%
South Africa	10.10%
Canada	1.40%
USA	4.10%
Switzerland	2.60%
Europe	3.60%
UK	2.50%
Hungary	6.70%
Russia	10.00%
Brazil	4.45%
Saudi Arabia	8.00%
Japan	1.20%

They have traditionally been inflation hawks; hence, unless the credit crisis widens to adversely affect their own financial system,

DISCLAIMER: E&OE: Investment Fund values change frequently and past performance is not indicative of future performance. No guarantee is given or implied and there is risk of loss as well as the opportunity for gain when investing in mutual funds.

Inflation – The Invisible Thief!

they will likely not cut interest rates.

Our Investment Strategy

As we live in an increasingly globalized world with increased trade, the transmission of higher prices often occurs quickly. Our assessment and forecast is that there is a high risk that we are heading into a period of heightened global inflation, with some countries already in the high inflation environment. In Canada, we have been protected by the rising Canadian dollar, that have reduced the cost of imports; however, as the rise of the Canadian dollar is unlikely to continue, even in Canada, inflation is likely to become more of a factor.

Inflation in fact may cause real interest rates to be negative. For instance, nominal U.S. interest rate for one year Certificate of Deposit is currently at 2.97%. If the year on year inflation rate stays at 4.1%,

depositors and savers are actually getting an interest rate of -1.13% [2.97% - 4.1% = -1.13%]. The situation is made worse if inflation rates rise even further and interest rates go even lower, as is the case in many countries at the moment. Some people believe that inflation is another way governments extract money from us through their mismanagement of inflation, although there is not much they can do to increase the supply of goods.

Investors in inflation ridden countries will benefit from holding assets other than cash, bonds, or income producing stocks. Most will prefer to hold other assets such as commodities including agriculture, gold, and oil as well as other hard assets like real estate, if financing is available at reasonable rates and assets are fairly valued. International stocks in emerging countries that used to be minor players in terms of market capitalization are beginning to represent a major force due to

their long term growth prospects. Real return bonds (sometimes referred to inflation protected bonds) is another avenue for diversification and investment protection. Prices of dividend paying stocks are another attractive avenue since dividend yields are normally higher than short term rate.

In this increasing inflationary world, we would recommend slightly adjusted investment risk approach. We will be pleased to meet with you for a further discussion of our investment outlook or if you have any concern, please contact us.

Best Regards,



Victor Whang
604.331.2524



Malcolm Ross
604.331.2521



Violet Smith
604.331.4465

DISCLAIMER: E&OE: Investment Fund values change frequently and past performance is not indicative of future performance. No guarantee is given or implied and there is risk of loss as well as the opportunity for gain when investing in mutual funds.