Media release

A CATCH 22 - US FEDERAL RESERVE PLAYS A WAITING GAME ON INTEREST RATES AS GEOPOLITICAL RISK ESCALATES

Johannesburg, 25 September 2014: There is an intriguing stand-off developing between the US Federal Reserve and emerging markets with the likes of China, India and Russia accusing the world's largest economy of once again inflating its way out of debt.

In her presentation titled *Investable trends – a shifting landscape*, given at the Independent Investment Intelligence (i3) Summit hosted by Sanlam Investments and Glacier by Sanlam in Johannesburg on 18 September, Dr Philippa Malmgren, President and founder of Principalis Asset Management, observed that unchecked global inflation was not only contributing to market uncertainty but could be fuelling geopolitical risk.

The US central bank repeatedly shifted the goalposts with regard to hiking US interest rates and it continues to inject billions of dollars of liquidity into global financial markets. "The Federal Reserve's extensive quantitative easing programme – implemented simultaneously with other developed markets – is driving inflation rates higher in countries around the world," said Malmgren.

One of the consequences of excess liquidity is a growing disconnect between share prices and asset managers' assessment of the underlying economy. High market valuations contrast strongly with gloomy growth prospects in numerous country markets.

As analysts wrestle with these often absurd valuations, property and food prices in the developed world are soaring too. Apartments in New York, London and Hong Kong are changing hands for absurd sums of money while the price for US beef and milk are at all-time highs. Americans are paying 83% more for butter this year than last, a phenomenon more commonplace in emerging markets.

Consumers are treating official inflation data with suspicion as it no longer reflects their real world experiences. “Wherever you go in the world the central bank data suggests that inflation is in check and significantly lower than the public perceives it to be,” said Dr Malmgren.

Most consumers are less concerned with aggregate price inflation than with the prices that directly affect them. It is a widely held view, for example, that the price of a staple foods can lead to civil unrest, as evidenced when wheat and bread prices skyrocketed in Egypt in the run-up to the Arab Spring uprising.

Asset managers and financial advisers need a deep understanding of the world economic outlook when assessing investment opportunities whether in South Africa or abroad. They must consider how markets, prices and risk will change in response to developing trends such as inflation, market uncertainty and geopolitical risk.

“We are in the beginning stages of a new cold war environment in terms of strategic security and defence issues, but also in financial markets,” said Dr Malmgren. Indebted governments are struggling to fulfil the promises made to their electorates and their austerity solutions are being met with heavy resistance, including social unrest.

Geopolitical risk escalates when governments take steps to address this internal strife, which explains the recent unrest in Ukraine (which is of strategic interest to Russia) as well as China’s manoeuvring in the South China Seas. The fact that we are seeing borders begin to degrade around the globe has a lot to do with the economic pressures that governments face.

“There is a strong chance the Federal Reserve will now cite geopolitics as the reason it cannot raise interest rates with the result that liquidity and inflation will persist far longer than expected,” said Dr Malmgren.

This might be good news for asset managers and financial advisers. Markets tend to do whatever is most painful for the majority of participants which means that equity markets could go a lot higher on the back of geopolitical risk, inflation and innovation.

To conclude, Dr Malmgren observed that global market stakeholders were familiar with both inflationary and deflationary pressures. She said that the inflation and geopolitics taking centre stage at present were not unusual and that investments had to be managed around them.

Investment decision makers will have to think long and hard about the assets they purchase and pay close attention to how much of the asset price is a function of management and how much is a function of developed world quantitative easing.

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