



Long-Term Interest Rate Risks Increasing

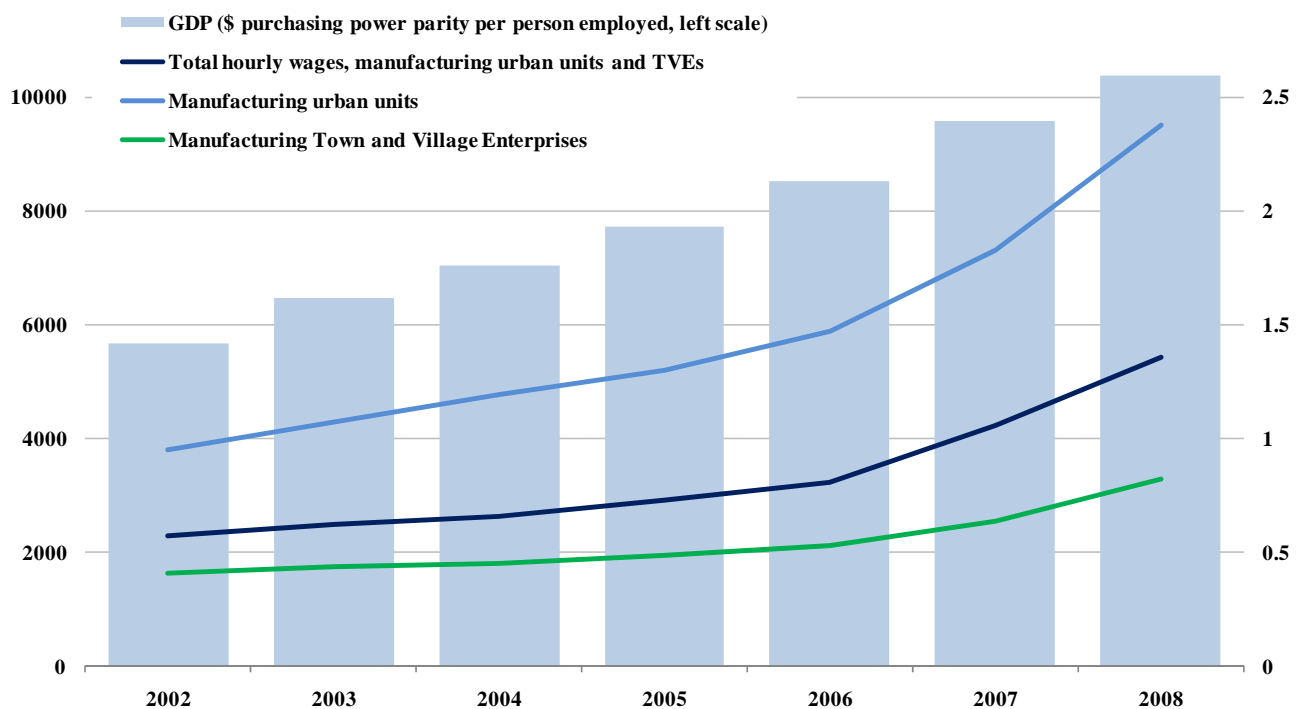
- The government averted a shutdown last Friday as Congress cobbled a last minute budget deal to fund federal agencies through September. Policymakers must now confront the more serious deadline to raise the debt ceiling by May 16. If it is not increased, the US would default on its debt. Given the consequences, we think a default is highly unlikely; but given the political rancor, long-term interest rates and gold have risen and the dollar has weakened. Sadly, most of what we are witnessing is political theatre. The differences that Republicans and Democrats were fighting over were around 1% of the 2011 budget and thus inconsequential to the overall budget problems. It is our contention that serious federal budget cuts are unlikely through the 2012 election unless forced by the bond market. Thus, to make inroads into the deficit, we think spending needs to be frozen and nominal GDP (real growth plus inflation) needs to rise at a least 6%. Given our view that real growth is constrained to around 2% for the next several years by structural forces (debt and housing), we expect that CPI inflation will gradually rise to between 2% and 4%. In our view these levels do not threaten the stock market but will ultimately (2012 and beyond) have negative consequences for the bond market.
- Oil rose to \$112 a barrel last week as the dollar continued to weaken, while other commodity prices rallied as well. While we think the threat of supply disruptions from the Middle East remain relatively remote, we would note that Saudi Arabia's cost of governing has been rising sharply. In order to run a balanced budget, Saudi Arabia needs to sell its oil for \$88 a barrel, up from \$68 a year ago, due to increased social spending to quell unrest, according to the Institute of International Finance (IIF). While current prices leave the Saudis with a budget surplus this year, the IIF notes that the break-even oil price to balance the Saudi budget will rise to \$110 per barrel by 2015. We expect this upward trajectory of Saudi 'ruling expenses' to put a floor under oil prices and limits their ability to be a swing producer. Our current view is that oil will not rise significantly above \$120 this year, but if we are wrong, the risks to growth will rise and we will need to become more defensive.
- Inflation pressures are also building from abroad. Given US retailers' reliance on sourcing from China, companies such as Wal-Mart are reporting overall price increases in end products. Although Chinese wages were still just 4% of comparable wages in the US in 2008, the rate of change matters. In China, real hourly manufacturing wages more than doubled from 2002 to 2008, rising at an annual rate of 12% (see Weekly Chart). Separate data suggest that real wage growth since 2008 has been even higher, averaging around 15%. With real US incomes flat (excluding government transfers, incomes have actually declined) Chinese wages are probably only around 6% of current US wages. Meanwhile, as the *Financial Times* points out, "Chinese labor productivity has been rising sharply at about 10% a year since the early 1990s and even more quickly in the past decade, due to technological progress, increased capital investment and rising human capital."
- While productivity has risen, nominal wages have been driving food prices higher (up 11% year over year), which is especially and perhaps ironically painful for rural areas where wage growth has been stagnant. Given the attendant risks to stability, China's central bank's efforts to rein in inflation have been fairly aggressive and are having some success, with money supply growth decelerating below the central bank's 16% target (from a peak of 30% a year ago). Moreover, the yuan has been allowed to appreciate about 4% versus the US dollar since last August and has been steadily making new highs, which we view as evidence that China sees exchange rate appreciation as a preferable means of rebalancing rather than inflation. We think this is letting other emerging market currencies appreciate as well since they have had to manage their exchange rates with an eye on China's export competitiveness, even as they too have suffered from inflation and central bank tightening.
- Given wage differentials between rural areas and the cities, urban migration in China is likely to continue, which is a stated goal of the government but a process they wish to manage. The government is also encouraging investment

to develop the interior of the country, since China’s coastal areas have disproportionately benefited. But while investment will continue to play a large part in China’s growth story, “consumption is likely to soar in emerging countries. This is now a specific objective of the Chinese government, which has realized the dangers of relying on demand from high-income countries” as the *Financial Times’* Martin Wolf wrote last week.

- The shift in emphasis from exports and investment to consumption is likely to lead to a marked downshift in economic growth (acknowledged by the Chinese government, which lowered its official five-year average GDP growth target in February to 7%). Furthermore, according to UC Berkeley economics professor Barry Eichengreen, et al: “Using international data starting in 1957, we construct a sample of cases where fast-growing economies slow down. The evidence suggests that rapidly growing economies slow down significantly, in the sense that the growth rate downshifts by at least 2 percentage points, when their per capita incomes reach around \$17,000 US in year-2005 constant international prices, a level that China should achieve by or soon after 2015.”
- Fortunately, a slowdown in Chinese growth with a simultaneous pick up in consumption is just what we think is needed for global economic rebalancing and sustainable recovery. Higher Chinese consumption (and currency revaluation), for example, is likely to translate into greater US exports, with the added benefit of easing protectionist impulses that might threaten trade. Hence, we are not only becoming increasingly bullish of global stocks, but of China in particular, especially sectors exposed to domestic demand, of which we are already overweight. We also have positions in emerging market currencies (including the Chinese yuan), which we think will also benefit from China’s growth transition.

The Weekly Chart: Chinese productivity offsetting wage gains

Chinese Manufacturing Labor Productivity and Hourly Wages



Source: Bureau of Labor Statistics, International Monetary Fund

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