Take cover from inflation fears

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Since the burst of its early '90s asset bubble, Japan still suffers from slow growth and deflation (negative inflation). Economists fear such a deflationary spiral where decreasing prices pressure production and wage levels and this trends to even lower prices. They favor a slow inflation rate, with growth rates in par with rising prices of goods and services.

A year earlier central banks (CBs) in the US and Europe were battling with deflationary fears in the face of post crisis meager economic growth, high unemployment, falling house prices and weak investor sentiment. CBs then made considerable monetary easing efforts to stimulate growth, battle unemployment and circumvent the Eurozone sovereign debt crisis. Consequently, the outlook in the Eurozone and the US has much improved; 2010 GDP growth rates leveled at +2% and +2.8% respectively, inflation of both hovered above 1.5% from near zero levels and unemployment has shown signs of improvement.

The effect, however, of the monetary easing efforts in certain asset classes and geographical regions has been such to insinuate forthcoming inflationary scenarios; prices of commodities such as food, oil and base metals have sharply rebounded from 2009 lows; the rise of the former has been predominantly driven by growing appetites in the emerging markets, supply disruptions from droughts in Russia and Australia and political unrest in the Middle East. The oil and base metals rally has mostly been due to the global economic recovery. Gold has continued its spike from investors taking shelter from volatile financial markets and currencies. In the emerging markets, equity flows reached record levels in '09, '10 and certain respective currencies are controlled by their governments to curb their ascent.

The push on prices may be bolstered as the US Fed's stance is to maintain quantitative easing through June to improve growth and unemployment and as the Eurozone may need to further tap into rescue funds for debt restructuring(s) of troubled economies or for any other adverse regional circumstances.

Investors' portfolios should thus be appropriately prepared:

Bonds inversely relate with inflation as future coupons are discounted by higher nominal interest rates that also propend higher with tightening CB monetary policies. Treasuries should be avoided with low yielding returns and higher sensitivity to interest rates; unlike corporate bonds they do not move with credit quality. To maintain a well balanced portfolio a bond allocation should be maintained but preference should be on debt of shorter maturities (lower interest volatility) and with floating rate coupons or convertible equity features. Although both are susceptible to inflation, floaters' coupons are tagged to a benchmark interest rate that is linked to the domiciled CB monetary policy; as such they benefit from a tightening monetary environment. Convertibles have an equity and debt component and thus appreciate with rising stocks but still provide the floor of a bond.

Equities are also vulnerable to inflation as corporate profits are squeezed via higher supply costs and suppressed economic growth following tightening CB policies. Best to reshuffle a proportion from emerging to developed markets with lower inflation rates and potential that will further unravel via a continuing recessionary exit. Financials, within the equity asset class can appreciate further as the fear of the effect of the imposed governmental reforms has subdued. Commodities act as conventional inflation buffers and portfolio risk diversifiers. Caution should be taken, however, to select less overheated sub sectors such as renewables, base metals and oil. Lastly, currencies such as the ruble, remnibi, rupee could advance further as their respective CBs continue their corrective monetary efforts and this can typically promote lucrative carry trades

Portfolio diversification is essential to mitigate the overall risk but to optimally reshuffle underlying asset classes is as important in a dynamic global economic environment.

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Food inflation boosts farm input firms

Producers of seed, fertilisers and other agricultural inputs are the beneficiaries of rising food prices as farmers scramble to increase output, according to fund managers of First State's Global Agribusiness Fund.

"Given where soft commodity prices are, farmer economics are more attractive. We expect strong growth in demand for farm inputs and expect to see acreage expansion," said Renzo Casarotto, a co-manager of the fund.

Global food prices are at record levels and are likely to remain so in the months to come, according to the U.N.'s Food and Agricultural Organisation.

The fund, which is domiciled in the UK and managed from Australia, invests in companies involved in the production, processing, distribution and marketing of agricultural products including seed, fertilizers, crop protection and machinery. It has around 22 mln pounds in assets under management.

Rising food prices helped the fund achieve returns of 26.7% in British pounds in 2010 following its May launch.

China's priority to provide affordable food for population

Any investors in the stocks of farm input companies, however, should also be wary that high commodity prices could dampen demand, Casarotto said.

"Food inflation is something that could lead to demand destruction."

For now, there are no signs that prices are reaching levels high enough to trigger this reaction, said Skye Macpherson, co-manager of the fund.

"The main difference from the 2008 spike is the oil price is lower, and you need oil to process, distribute and package food. Oil has a large impact on food inflation," Macpherson said.

Casarotto said food inflation was likely to be an ongoing concern in emerging markets, where a higher proportion of income is spent on food.

That includes China, where the government recently raised interest rates in a bid to tackle high inflation. People are waiting to see whether China's economic slowdown will have an impact on demand for commodities, Casarotto said.

"I would think that the biggest issue the Chinese government fears is social unrest. They will do everything they can to ensure there's adequate supply of reasonably affordable food," he added.

China's growing demand has led it to become a net importer of some commodities, for which it had been self-sufficient.

"Last year China imported 2 mln tonnes of corn, and this year it could be importing as much as 9 mln tonnes," Casarotto said.

FERTILE INVESTMENTS

Toronto-listed fertiliser company Potash Corp is the fund's largest holding and is attractive due to its ability to adjust production according to demand, Casarotto said.

Rising demand for fertiliser and anticipated merger and acquisition activity make the sector attractive, Casarotto said.

"If there is an overweighting in the portfolio, it is towards the nutrients sector," he added.

The fund invests as well in smaller fertiliser companies including Australia-listed Aguia Resources, which has a potash and phosphate project in Brazil, and Celamin Holdings, which has a phosphate project in Tunisia.

In other sectors, Syngenta, the world's largest agrochemical group, also trades at an attractive valuation, Macpherson said.

"Traditionally the company was more crop protection-based, but the GM (genetically modified) portfolio has grown significantly," Macpherson said.

Farmland companies also provide attractive opportunities as private companies that are buying up farms look to list on exchanges.

"Most farmland internationally is privately owned, so fund investments are more limited by the number of listed companies, but we think that will change," Macpherson said.

The equities fund has a three-to-five-year investment horizon and takes only long positions. In the event commodity prices decline, the fund would look to invest in the companies that benefit from lower prices, Casarotto said.

"The beneficiaries of such a move would be the protein producers," such as producers of chicken, pork and beef, whose input costs would fall, Casarotto said.

COMMENTARY

Greek bank mergers will serve no purpose

Shavasb Bohdjalian

National Bank of Greece kicked off a government-sponsored consolidation of the sector with an all-share bid for third-largest lender Alpha Bank valuing it at around 3 billion euros but the move was quickly rejected by Alpha, which said the 8-for-11 share offer was not in its shareholders' interests, opening the way for a takeover battle.

NBG's offer gives the smaller bank's shareholders 29 percent of the combined group and the right to nominate the non-executive chairman. But it puts NBG firmly in control with the remaining 71 percent and the chief executive position.

It is the second time the two lenders have attempted to get together. In 2001, despite an agreement at board level, the deal fell through because of management disagreements.

NBG's 8-for-11 share offer sparked a rally in Greek bank shares with the shares of other prominent Greek lenders Eurobank and Piraeus Bank closing with gains of over 15 percent after NBG revealed the merger proposal.

NBG said the new group would have the strongest balance sheet in Greece after the completion of a capital plan worth 2.8 billion euros. Both NBG and Alpha had their balance books hammered in the first nine months of last year with each recording a fall of over 70 percent in net profits.

NBG said the combined bank would have a Core Tier 1 ratio of 10.7 percent, ranking among the best capitalised banks in Europe and could generate annual synergies of 550-700 million euros.

But the real reason why the government is pushing Greek banks to merge, cut costs and raise capital is because faced with shrinking deposits, Greek banks are exclusively reliant on European Central Bank funding for their liquidity needs as access to wholesale funding remains mostly shut because of wider Greek sovereign debt concerns.

Personally I'm skeptical if the desired cost synergies will be achieved and at what cost. It is ironic that NBG failed to mention how many thousand employees from both banks will be made redundant and how many branches will be closed and if the back-office systems of both banks are compatible or a new system needs to be purchased.

The merger will also give both banks the opportunity to "clean" their books of possibly billions in more doubtful debt that they have on their books, which means a year later, the promised profits may not be delivered.

Furthermore, a merger will serve no real purpose if there are no growth prospects. The US corporate model is perhaps better for Greece to follow at this stage, whereby each and every institution cuts its unnecessary expenses, increases productivity and becomes more efficient before contemplating to merge with another weak institution. When Greek banks become efficient, and when prospects improve, then they will become takeover targets and that's when the Boards should rush to close deals.

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Pension insurer sees 150% increase in UK deals

Deals in which British companies pay insurers to take on pension liabilities could more than double this year as stabilising asset prices open the market to more firms, a leading insurer said.

David Collinson, a partner at Pension Corporation which partially or totally takes on pension liabilities, told Reuters such transactions, known as buyouts and buy-ins, dramatically slowed during the financial crisis but were now within "chequebook distance" for more firms.

Pension Corporation, which manages 4 bln pounds, says the industry could see up to 8 bln pounds in deals in the first half of the year, up from 3.2 bln pounds a year ago.

Pensions consultant Lane Clark and Peacock estimates the deal flow could reach 12 bln pounds for the whole of 2011.

Buyouts are used by companies to pass on pension assets and liabilities which as retired workers live longer can in extreme cases threaten an employer with insolvency.

Buy-ins are generally used to insure a scheme's liabilities but leave most of the assets within the scheme.

Collinson attributed much of the lift to greater willingness among insurers to take payment for taking on pension liabilities in non-cash assets such as property amid stabilising markets, opening that market to more companies.

The number of buyout transactions at Pension Corporation paid for in non-cash assets is expected to increase to ten this year, from one in 2010, Collinson said. Until recently, when pension deficits were larger and pension funds were nursing heavy losses after stock market falls, companies could only pass on liabilities for hard cash paid up front as well as liquid assets such as gilts and bonds.

"For every company that can afford to pay all the money upfront in cash, there are several others that cannot afford to do that," Collinson said.

Greater flexibility in payments in the buyout market mirrors a trend among British companies to cover deficits with hard assets, including in the case of Diageo, which pledged whisky against its British pension fund's deficit.

"Some of the insurance companies are becoming a lot savvier about assets," said Charlie Finch, partner at Lane Clark and Peacock, who has advised on buy-outs since the industry's early days.

As well as "a competitive advantage", insurers gain assets which may become more valuable in the long run, Finch said.

"I certainly see deals becoming more sophisticated going forward. If one insurer takes on a property portfolio that gives a better price than cash it can give it a competitive hedge over another insurance company," he said.