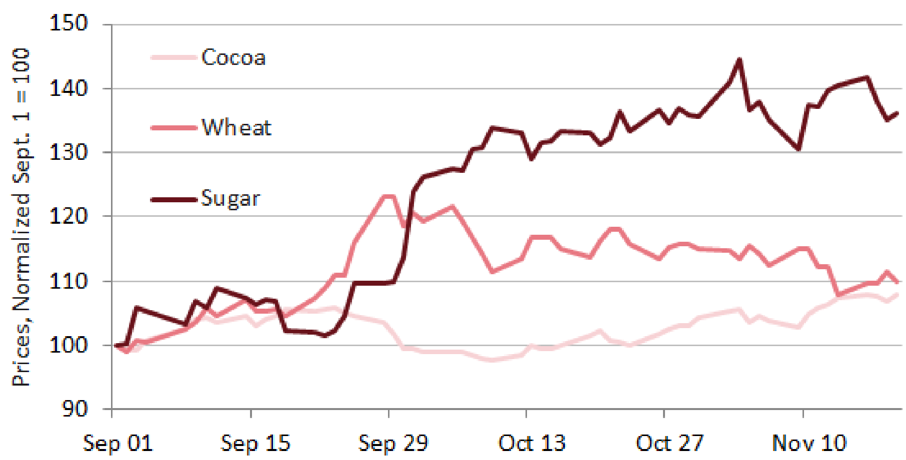
GLOBAL ECONOMY

GUEST COMMENTARY BY CHRISTOPHE BARRAUD OF MARKET SECURITIES

Don't Ignore the Risk of a Sharp Rebound in Global Inflation

Some Commodity Prices Have Risen Since the Summer



Source: Bloomberg/Market Securities BloombergBriefs.com

Global inflation has been under significant pressure for months, suppressed by low wage growth, a global slowdown, the rise of the collaborative economy and a currency war. While the trend is likely to persist due to structural factors, investors shouldn't ignore the risk of a sharp rebound, stemming from supply issues for oil and agricultural-commodity prices.

One possible spark could originate from Saudi Arabia's fiscal and current account deficits which could lead it to push OPEC to cut oil production in order to boost prices.

The decline in oil prices (which provide 80 percent of the Saudi Arabia's revenue) is a serious problem given that the country spends a lot of resources to alleviate public discontent. It increased military spending, playing a role in the intervention against neighbouring Yemen, and perks for Saudis still include education, infrastructure projects and cheap energy. According to Riyadh-based Samba Financial Group, fuel subsidies will cost Saudi Arabia as much as $52 billion this year, or 8 percent of GDP.

King Salman, who is struggling to establish his authority, is unlikely to push for politically difficult cost-cutting measures despite a fiscal gap exceeding 20 percent of GDP this year (according to a forecast from the International Monetary Fund).

In these conditions, the government is trying to compensate for the decline in oil prices through volume, in order to protect its global market share, but also by tapping foreign reserves, selling bonds and even delaying payments on existing projects. According to the Saudi Arabian Monetary Agency's monthly report, net foreign assets held by the central bank dropped to $646.9 billion in September. That is the eighth consecutive month of decline and the lowest recorded since November 2012.

As a consequence, Saudi Arabia will either keep on drawing down foreign assets (savings would run out after six years, according to our calculation) or change its strategy by cutting oil production.

Separately, El Niño (a climate cycle in the Pacific Ocean with a global impact on weather patterns) is starting to push up prices for agricultural commodities.

It occurs at various intervals (usually two to seven years), and lasts nine months to two years. The cycle starts when warm water in the western tropical Pacific Ocean shifts eastward along the equator toward the coast of South America.

The World Meteorological Organization recently said that El Niño was already " strong and mature." It also added it was likely to strengthen further and could become one of the strongest on record.

The effects are already being seen in countries in Africa including Ethiopia, Somalia, Kenya and Malawi, and across Central America. One of the most severe droughts on record has led to 3.5 million people in Guatemala, Honduras and El Salvador needing food aid. Ecuador on Nov. 18 declared a "state of exception" in most provinces, unlocking extra funding and ordering public institutions to prepare for El Niño's arrival.

In South East Asia, El Niño has already been associated with a drought which increased wildfires in Indonesia. It also reduced the impact of the monsoon in India, while the U.S. has experienced the warmest October since 1963.

In this context, despite a renewed rise in the dollar (which is negative for commodities), sugar, cocoa and wheat prices have significantly increased since the summer. This trend could spread to other commodities.

Christophe Barraud is Chief Economist and Strategist at Market Securities in Paris.