Gerard Lyons
INSIGHT

Inflation still a temptation for dealing with western debt

Inflation may become the big challenge for policy makers across the globe in 2013, but in very different ways. Across Asia and many emerging economies, central bankers will need to take pre-emptive action to curb inflation. In contrast, across some western economies, central banks may need to resist rising political pressure to accommodate inflation as a stepping stone to stronger growth and debt elimination.

This would provide another sign of a tale of two worlds that has been evident since the crisis began. Despite the lack of demand in the west the global economy has continued to grow. In nominal terms it is up from $62tn before the crisis and is set to reach $74tn by the end of this year. Some of this is inflation, but the bulk is real growth led by emerging economies. This year, despite considerable downside risks, the world economy could see its strongest pace of growth since 2010.

Inflation needs to be taken seriously across emerging economies. Many of them are at the stage of the economic cycle where they have hit inflation or trade problems. An inflation shock may come from food and energy prices. Increased demand for these has been driven by emerging economies. For instance, oil demand from advanced economies has fallen from 46.3m barrels a day in 2009 to a likely 45.7m b/d this year, according to the International Energy Agency. In contrast, emerging market demand is up from 39.1m b/d to 44.8m b/d over the same period. Similar trends in demand are seen in other commodity markets.

High commodity prices . . . demonstrated not just strong demand but lack of investment in supply potential to cope

High commodity prices both before the crisis and in recent years demonstrated not just strong demand but a lack of investment in supply potential to cope. This is now being addressed, but with different time lags before fruition.

The net effect is that commodity prices appear to have a firm floor and a soft ceiling. This year the floor is demand from emerging economies. The soft ceiling, meanwhile, reflects geopolitical risks that could push oil prices higher, while supply disruptions could easily see food prices rise.

Rising food and energy prices will add to wage pressures, and alongside a rebound in domestic demand this is likely to contribute to an ability to pass on higher costs and a feed-through of inflation pressures.

All this will be compounded by capital inflows from the advanced economies, where central banks in the US, UK, Europe and Japan look set to keep interest rates low for some time. This means there is ample liquidity looking for a home. The likelihood is this money will seek out emerging markets, many of which do not have the absorptive capacity to cope with further inflows.

The dilemma for many emerging economies is they fear raising rates in case it attracts more money

This leads to two potential vulnerabilities. One is financial and is the need to avoid the dangerous build-up of leverage, although the lesson of the crisis is to look at gross and not net capital flows in trying to spot this.

This is not yet the issue across emerging economies, although in some leverage is rising. The second vulnerability is economic and is more immediate, as flows feed asset price inflation, particularly in equities and real estate.

The dilemma for many emerging economies is they fear raising rates in case it attracts more money. But if rates stay low this will feed domestic credit growth and future inflation.

This could lead to more interventionist measures. Hong Kong, for instance, in December stepped in to tax foreign buying of properties. Others may seek to use capital controls, a policy now endorsed by the International Monetary Fund. The key will be to use monetary policy more effectively, and in many cases tighten using interest rates or macroprudential measures.

Equally tough dilemmas are likely to face central banks in the west, where the economic cycle could not be more different. Regulatory and fiscal policies appear more pro-cyclical than needed. Thus monetary policy in the west has become the shock absorber, although it can only achieve so much and not solve underlying problems.

Unorthodox monetary policy is now the norm. Minimising downside risks, averting deflation and helping restore financial sector stability have been key.

Now the biggest economic challenge is to continue to boost lending in the face of a breakdown of the monetary transmission mechanism. Yet the desire to have a stronger recovery means there is still pressure for central banks to do more, as highlighted by the debate over the Bank of England's mandate.

In 2013, central banks across the emerging world need to guard against inflation. In contrast, in the west they need to guard against a greater political acceptance of inflation.

Gerard Lyons is chief economic adviser to the mayor of London

Trafigura warns over commodities

Trading house says 'buoyancy' unlikely

Mixed materials outlook for China

By Javier Blas in London

Commodities are unlikely to enjoy a return to the "buoyancy" of the past decade – when copper, aluminium and oil prices hit record highs – as China's use of raw materials slows, a top trading house has warned.

Claude Dauphin, chief executive of Trafigura, told bondholders the "extreme pessimism" of 2012 about commodity prices would probably dissipate as economic growth improved. But he added: "A return to [the] buoyancy of the commodities markets between 2003 and 2007 is unlikely."

Mr Dauphin is one of the most reserved – and powerful – figures in the commodities trading industry. The Trafigura boss never speaks in public, but does write a letter to lenders and bondholders as part of the annual report, which offers a window into his thinking.

Trafigura is the third-largest independent oil trader, behind Vitol and Glencore, and the second-largest in base metals, such as copper, after Glencore.

The letter, seen by the Financial Times, suggests a period of stable commodities prices as global economic growth accelerates from 3 per cent in 2012 to 3.5 per cent this year.

The comments are important beyond the trading industry. Large companies such as ExxonMobil and BHP Billiton and countries from Saudi Arabia to Chile have benefited for a decade from rising commodities prices.

'Growth in the US and the eurozone will continue, at best, to be slow'

Mr Dauphin offered a mixed outlook for China, the main engine of commodities demand growth during the past decade.

On the one hand, China was moving towards a period of growth that would be "less materials intensive" than in the past, he said. "This is likely to manifest itself in slower prolonged growth as opposed to an absolute decline in consumption."

On the other hand, "China's growth trajectory [in 2013] is likely to exceed that of 2012", he added.

The chief of Trafigura was far less optimistic about developed countries. "It is evident that in light of fiscal austerity and household and corporate deleveraging, growth in the US and the eurozone will continue, at best, to be slow."

Mr Dauphin founded Trafigura in 1993 with a group of other senior traders who left Marc Rich & Co, the trading house that, after a management buyout that year, transformed itself into the company that is Glencore today.

Trafigura told bondholders in 2010 that Mr Dauphin owned "less than 20 per cent" of the trading hou[se] while "over 500 seni[or] employees" control the re[st].

The company, whi[ch] moved its legal offices [and] trading from Geneva to Si[n]gapore last year, has vow[ed] to remain private. B[ut] Trafigura has suggested [it] might float its oil termin[al] business, Puma Energy, [in] 2014 at the earliest.

Trafigura reported [net] income of $991.9m in t[he] year to September, do[wn] 11 per cent from last yea[r's] record $1.11bn. The resu[lts] were boosted by sales [of] mining assets, includi[ng] shares of Anvil Mining a[nd] Tiger Resources.

Switch to equities big risk for Asia junk bonds

News analysis

Levels of issuance, particularly in China, also a cause for concern, find Paul J Davies and Josh Noble

Safe as houses is a saying unlikely to resonate with investors in Asian bond markets. Not only have they seen explosive volumes for the first month of the year, especially in the junk bond market, but this wave of issues has been dominated by Chinese property groups – long one of the riskier sectors in investors' minds.

Bond markets around the world are beset by commentary worrying about a price bubble as low interest rates almost everywhere, but led by the US, have driven investors on a hunt for yield.

In Asian high-yield markets more than anywhere else, investors face three distinct risks, any one of which could blow a hole in their bond portfolios. Borrowers might default, interest rates could start to rise, or most immediately, liquidity could dry up if another asset class, namely equities, starts to look more attractive.

There are plenty who still see huge risks in the Chinese property sector due to overcapacity. Andy Xie, an independent economist, recently wrote on the Financial Times' beyondbrics blog of 50 Hong Kongs being under construction on the mainland.

However, other analysts say the market is in much better shape since a crackdown on the supply of credit to the sector in 2011. Christie Ju at Jefferies in Hong Kong says 2012 was a solid year, with residential transactions up 1.5 per cent on the previous year and average selling prices climbing 8 per cent. Analysts at Credit Suisse reckon house prices in the big cities will rise 5 per cent this year, at least.

Chinese property groups have accounted for six of the 10 biggest issuances in a record January that saw $7.8bn of high yield bonds sold – about four times the previous record and more than half the total deals in all of last year. Add in equity raisings and property groups have between them raised more than $6.5bn of fresh funds, according to Ms Ju.

Raja Mukherji, head of credit research Asia at Pimco, says most of the property companies coming to market have decent long-term prospects, adding that urbanisation means there is real demand growth underpinning the sector.

This is in contrast to companies in the steel sector and other basic industries, where overcapacity is a significant problem. Groups from these sectors have not even tried to issue bonds in spite of the appetite for risk that has seen risk premiums, or spreads, shrink to less than 10 per cent – about half of what they were a year ago – and terms and conditions get looser.

The bigger question in the short term is whether the market can cope with the level of issuance it has seen. Some deals have already struggled once they have begun trading as what looked like strong support faded away. Agile, one of the better known Chinese property companies, has seen the price of its bonds slide to 95 cents on the dollar in their first week of trading. Other deals have also had to be delayed or reduced in size.

Mark Follett, JPMorgan head of high-grade debt capital markets Asia, excluding Japan, says this is a good sign. "You would have seen in prior years people pushing the market [in terms of tighter spreads and looser covenants] until something broke and the market closed. This year you have seen some deals trading worse without closing the market. This is a sign of the growing depth and maturity in the Asian market."

Mr Mukherji disagrees. "You can already see a little bit of fatigue coming into the market," he says. "This is not so much a sign of maturity, it's because investors have been taking pain on other deals."

One of the biggest immediate risks to the market, according to some, is an improvement in economic conditions, which may persuade private bank clients to switch back to equities. Some private banks are beginning to advise such a move now, before others realise the chance for further price gains on top of high coupons has passed.

"The private bank-driven, momentum-driven side of the market is very risky and will hit trouble at some point," says one experienced debt markets banker.

However, Mark Matthews, head of research in Asia at Julius Baer, is relatively sanguine: "I don't think you will get capital growth [from high-yield bonds] this year in the same way as last year – but you can still clip a good coupon."

Risky business

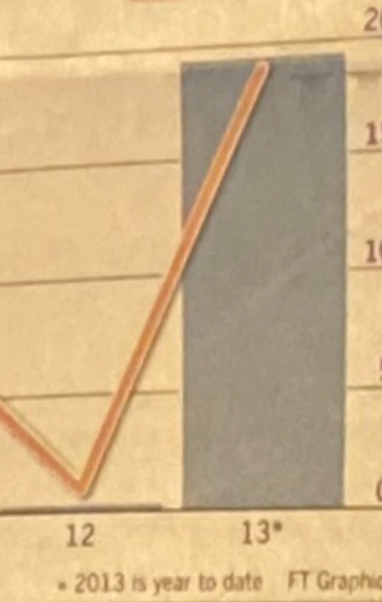
Selected top Chinese property deals this year

Shimao Property Holdings

Country Garden Holdings

Agile Property Holdings

Kaisa Group Holdings



Asia ex-Japan high-yield bonds...

Issuance: Value $bn / Number of deals

1995 2000 05 10 13*

Source: Dealogic

...have strong start to 2013

Asia ex-Japan high-yield bond issuance in January: Value $bn / Number of deals

2010 11 12 13*

* 2013 is year to date FT Graphic

Opec upbeat on crude oil price averaging $110 in 2013

COMMODITIES

By Ajay Makan in London

Opec has struck an upbeat tone about the oil market for this year, anticipating prices of about $110 a barrel on average for 2013.

Abdalla El-Badri, Opec secretary-general, added that the oil cartel, which accounts for 40 per cent of global supplies, would probably keep its production stable for the time being, after member countries cut output in November and December.

"As of now I think the situation is really improving. When I see growth in China is improving, growth in India is improving, when I see growth in the US is improving, I think that unless something dramatic happens in 2013, it will be a repetition of 2012," he said.

Brent crude, the global benchmark, set a record annual average in 2012 of roughly $111.50 a barrel. The benchmark closed at or above $100 every trading day last year, bar 24 days in late June and early July.

Weak global growth and increased oil production in the US, traditionally Opec's largest customer, have led some analysts to forecast downwards pressure on the price of oil this year, as well as an erosion of Opec's ability to influence prices.

Saudi Arabia, Opec's largest producer, cut production to its lowest in a year in December. The kingdom supplied more than 10m barrels a day in mid-2012 to meet a seasonal increase in demand and offset the loss of Iranian production. But it has since cut output to 9.3m b/d, according to the International Energy Agency.

Mr El-Badri denied Opec was reducing production to accommodate increased US supply. He said the organisation welcomed increased diversity of supply.

"US unconventional production is evolutionary for the market, not revolutionary," he said. "Forecasts suggest 3m b/d in 20 years – that is not a threat to us," he said at an oil conference organised by Chatham House, the London-based think tank. Opec countries produce about 37.5m b/d.

Mr El-Badri also signalled a more relaxed approach to enforcement of production quotas. Even after Saudi Arabia's cut in December, Opec members exceeded their 30m b/d quota by 400,000 b/d.

While repeating the official line that "no country should exceed their quota", Mr El Badri said of the 30m quota: "This a sign, you know." He added that Opec was not looking to cut production while some countries continued to struggle.

Source: Thomson Reuters Datastream

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Canadian day-trading group fined £8m for London abuse

By Brooke Masters in London

A defunct day-trading company controlled by a prominent Canadian entrepreneur must pay an £8m fine for market abuse for moving share prices on the London Stock Exchange through rapidly placing and cancelling orders on thinly traded companies, a London tribunal has ruled.

The ruling against Peter Beck's Swift Trade represents a significant and complete victory for the Financial Services Authority, which had sought to penalise the company for "layering" – using multiple orders to move share prices in a particular direction.

A finding against the watchdog could have undermined the FSA's recent efforts to enforce its strict market abuse rules on overseas investors who dabble in the UK markets.

"It is as serious a case as might be imagined," the Upper Tribunal, which hears appeals from the FSA disciplinary process, wrote in its decision. "The conduct of which Swift Trade was guilty amounted to a cynical course of intensive manipulation of the LSE.

"Left to ourselves, we might well have concluded that £8m was insufficient."

The FSA said day traders used Swift Trade's facilities to place and cancel tens of thousands of trades between 2007 and 2008, sparking complaints from other market participants and netting Swift Trade more than £1.75m. Swift Trade switched brokers after the LSE complained about the trading patterns.

£1.75m

Sum that Swift Trade gained through 'layering'

Michael von Pommern-Peglow, the attorney who represented Swift and Mr Beck before the tribunal, called the decision "very disappointing" and said they were considering an appeal. "If the decision stands, CFD [contract for difference] trading by non-UK regulated firms will effectively become regulated by the FSA through the back door."

Tracey McDermott, FSA enforcement director, called the Swift Trade case "a particularly cynical case where a business model was based on market abuse . . . layering is abusive. We expect brokers and [direct market access providers] . . . to monitor their clients' trading activity closely."

The panel rejected claims that the watchdog did not have jurisdiction over Swift Trade because it was Canadian and placed its orders through the UK arms of first Merrill Lynch and then Penson.

The ruling confirmed the FSA's power to bring market abuse cases based on profits made from trading in swaps and contracts for difference rather than directly in equities.

Swift Trade has previously paid C$400,000 to the Ontario Securities Commission for compliance and control failings. The US Securities and Exchange Commission last year banned Mr Beck from the US securities industry for two years over allegations that he ignored red flags that day traders at another firm he founded were engaging in layering.