Weekly Economic Update

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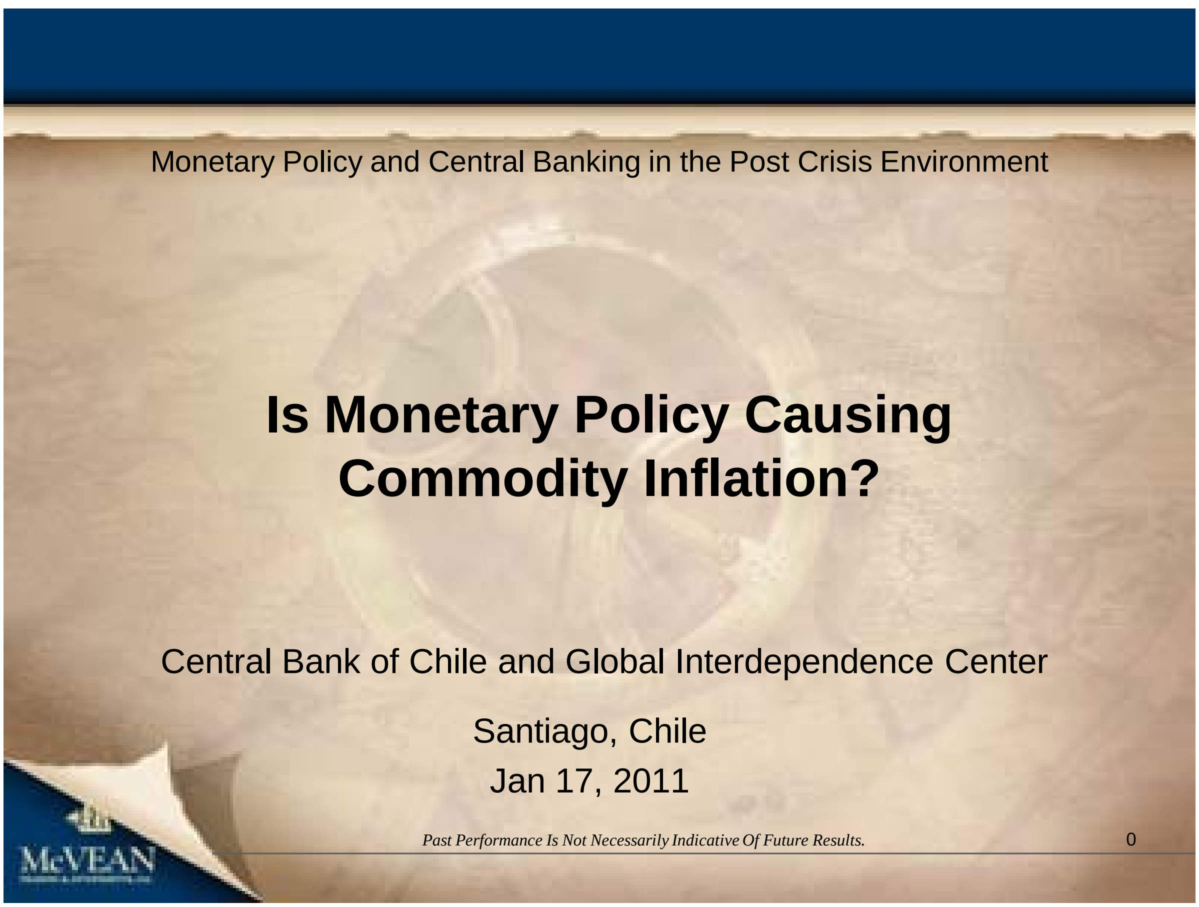
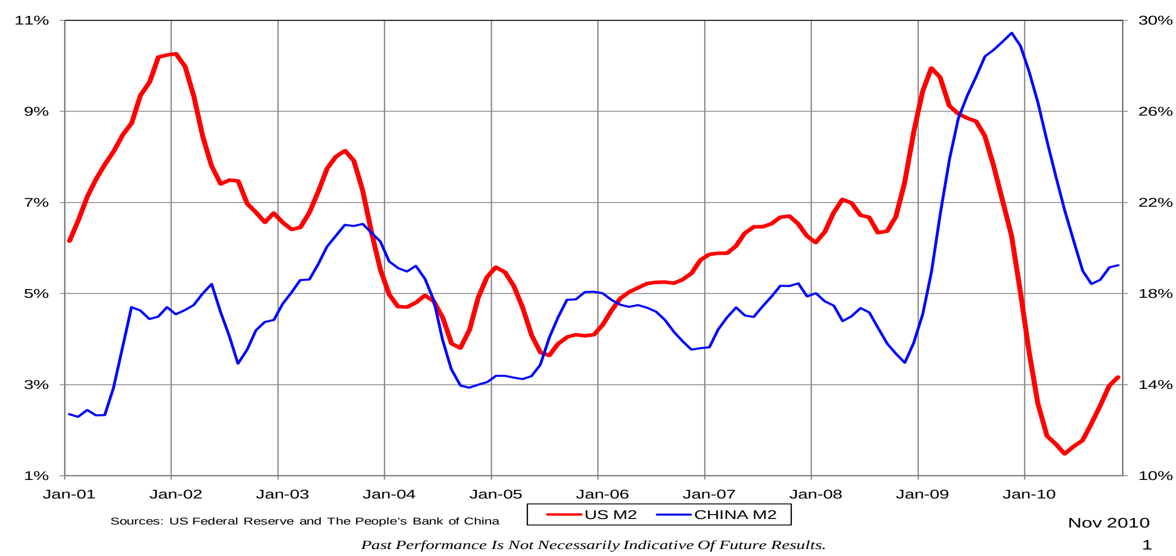
I am traveling tonight to Santiago, Chile for a conference sponsored by the Global Interdependence Center. I have been asked to discuss the question "Is monetary policy affecting commodity inflation?" and have included the presentation for our clients and friends below.



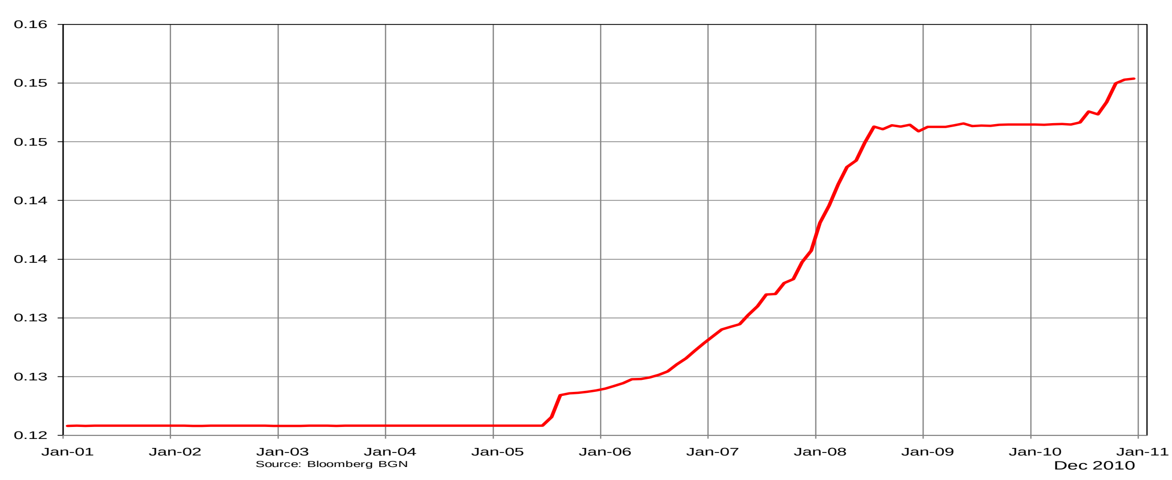
In our view the answer is yes, monetary policy is causing commodity inflation -- but it is far more complex than simply more money causes higher prices. The transmission chain involves mistakes by the Federal Reserve, the US Congress, and the Chinese Government, as well as the underlying fundamentals of international supply and demand which favor relatively higher prices for commodities regardless of the global backdrop of monetary policy.

US M2 vs CHINA M2

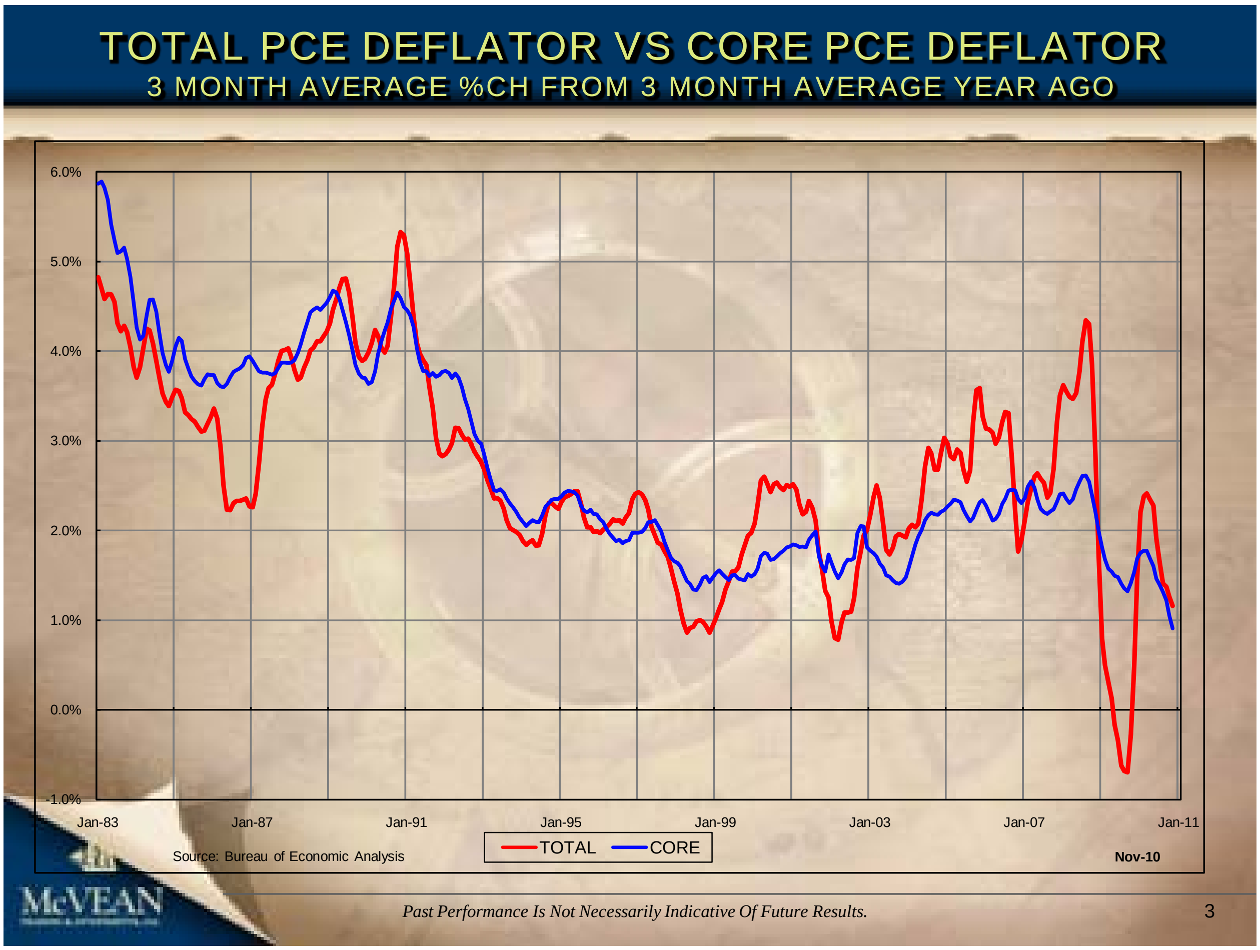


Right now, the key monetary policy in the world is the decision by the Chinese government to keep their currency effectively linked to the US dollar. They do this to protect their export markets – but it actually offers little protection. A country with a linked currency has effectively given up control over its money supply to another nation. Note the only time Chinese and US M2 growth were not closely correlated was from 2005 through 2008 when the yuan was rising at about a 6% annual rate.

CHINA YUAN IN US DOLLARS



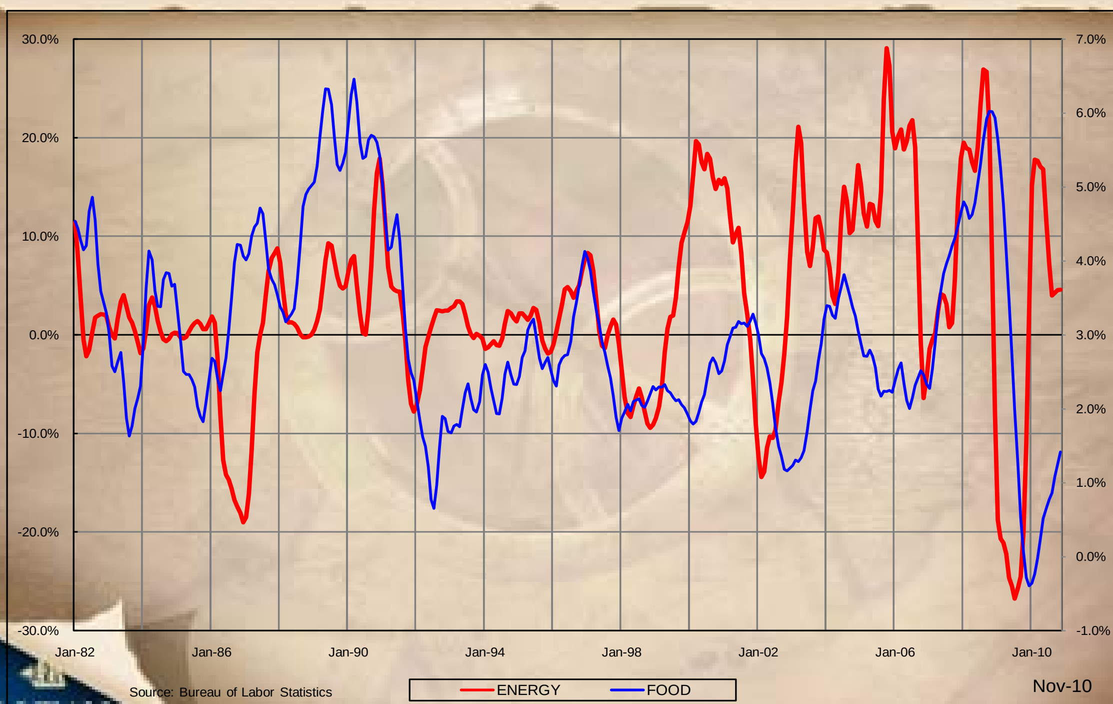
Many small countries peg their currencies to maintain stability with their larger trade partners. However, in a fixed currency block, the regions that are growing fastest will always see prices rise faster. This is the process which attracts more resources (supply) to that region, while at the same time moderating demand. The difference in price appreciation is usually most noticeable in real estate assets as they cannot be moved or easily expanded. That is why inflation is higher in China today, and particularly in the real estate assets of tier one cities like Beijing, Shanghai and Shenzhen. So while China appears to be defending its export markets with a fixed currency, the result is higher labor and asset inflation which drives up the cost of Chinese goods anyway. You cannot fool the invisible hand.



As the US is running monetary policy for China and a number of other nations with managed currency policies, the current very easy setting is the second critical global factor affecting inflation. The Federal Reserve, unlike many central banks, has a dual mandate: to keep inflation low and stable and to maintain maximum sustainable employment. At present, unemployment is far too high, and inflation measured by the Fed's preferred core personal consumption deflator (ex-food and energy) is below its 2% target. One problem is the Fed's preferred measure is not a very good measure of inflation, because for most of the past decade, the opening of China has produced lower prices for specifically core PCE goods.

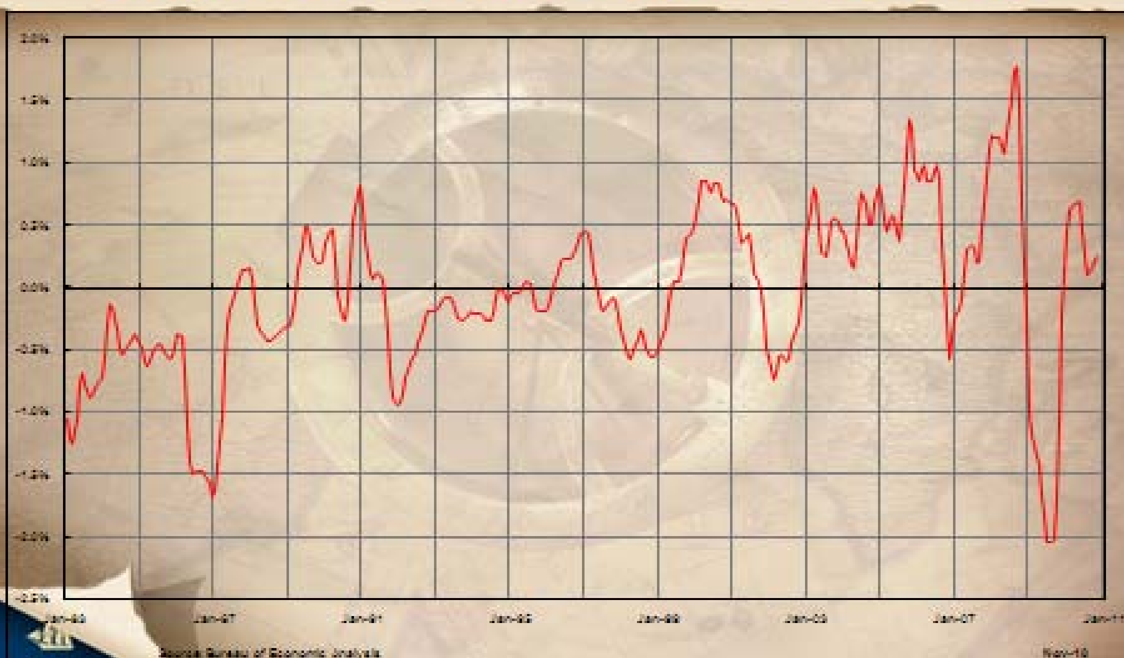
FOOD CPI VS ENERGY CPI

3 MONTH AVERAGE %CH FROM 3 MONTH AVERAGE YEAR AGO

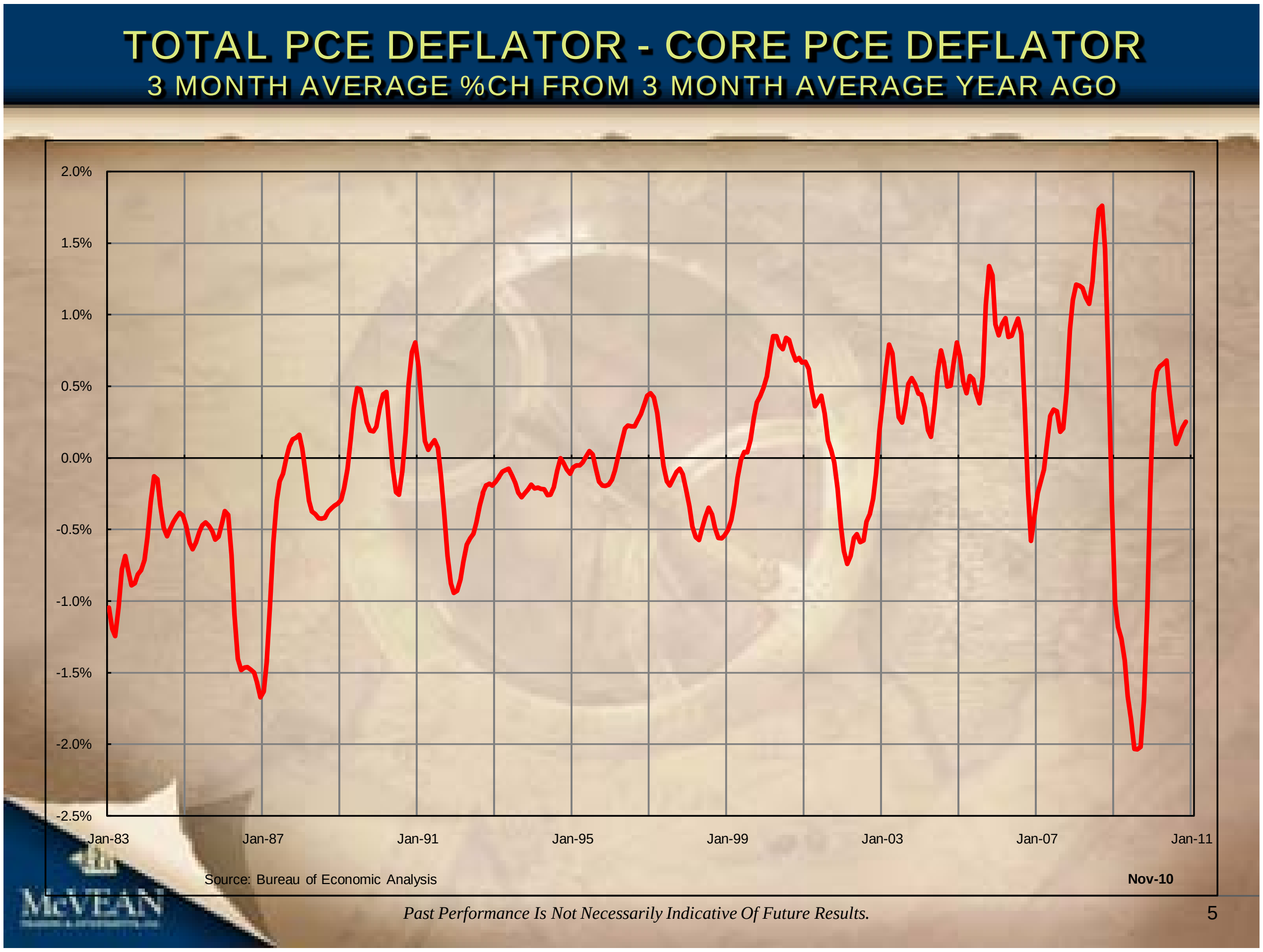


TOTAL PCE DEFLATOR - CORE PCE DEFLATOR

3 MONTH AVERAGE %CH FROM 3 MONTH AVERAGE YEAR AGO

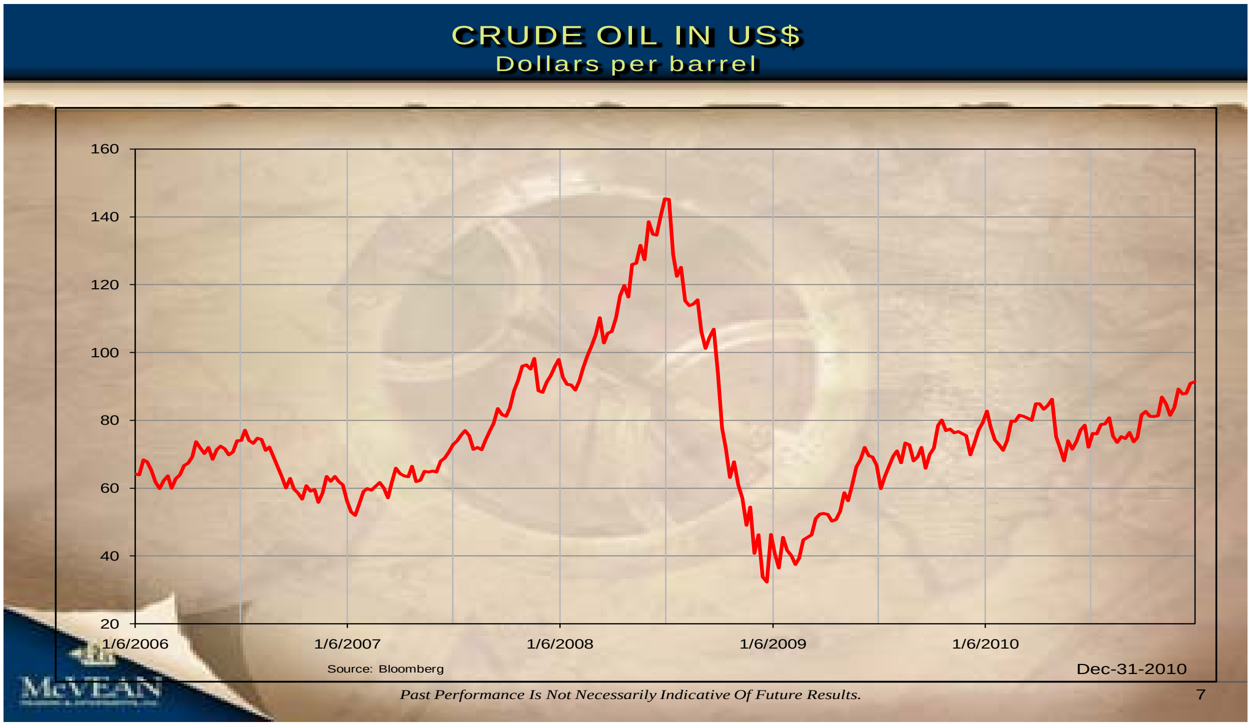


Food and energy are left out primarily due to their volatility, but on trend since 1980, food and energy have gone from being a drag on overall inflation to being a significant contributor.

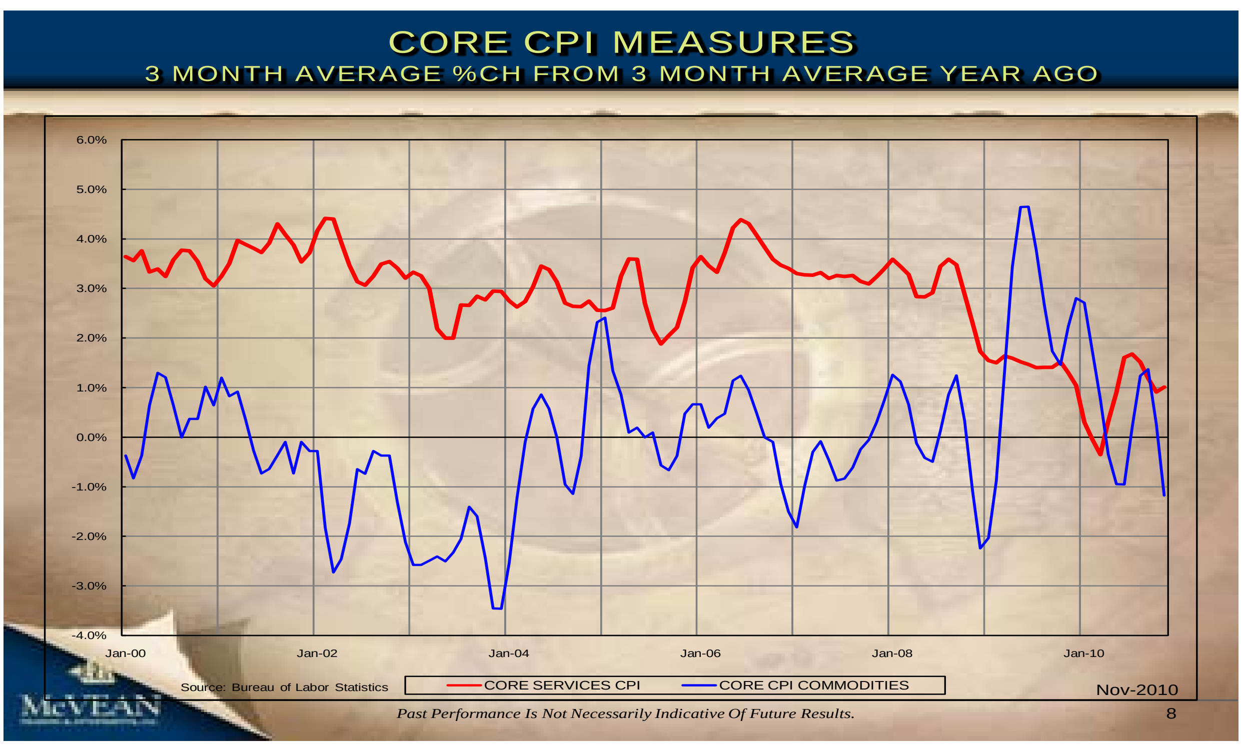


Moreover, purely consumer indicators leave out the government and investment sectors. By 2006, it was obvious in the broader GDP deflator that US inflation was well above the Fed's target – primarily because of inflation in the construction sector. The liberal US monetary policy allows all prices to rise faster than they would otherwise and accelerates the speed with which relative prices change. It is hard to get price decreases even when warranted, and easier to get price adjustments when everything is going up.

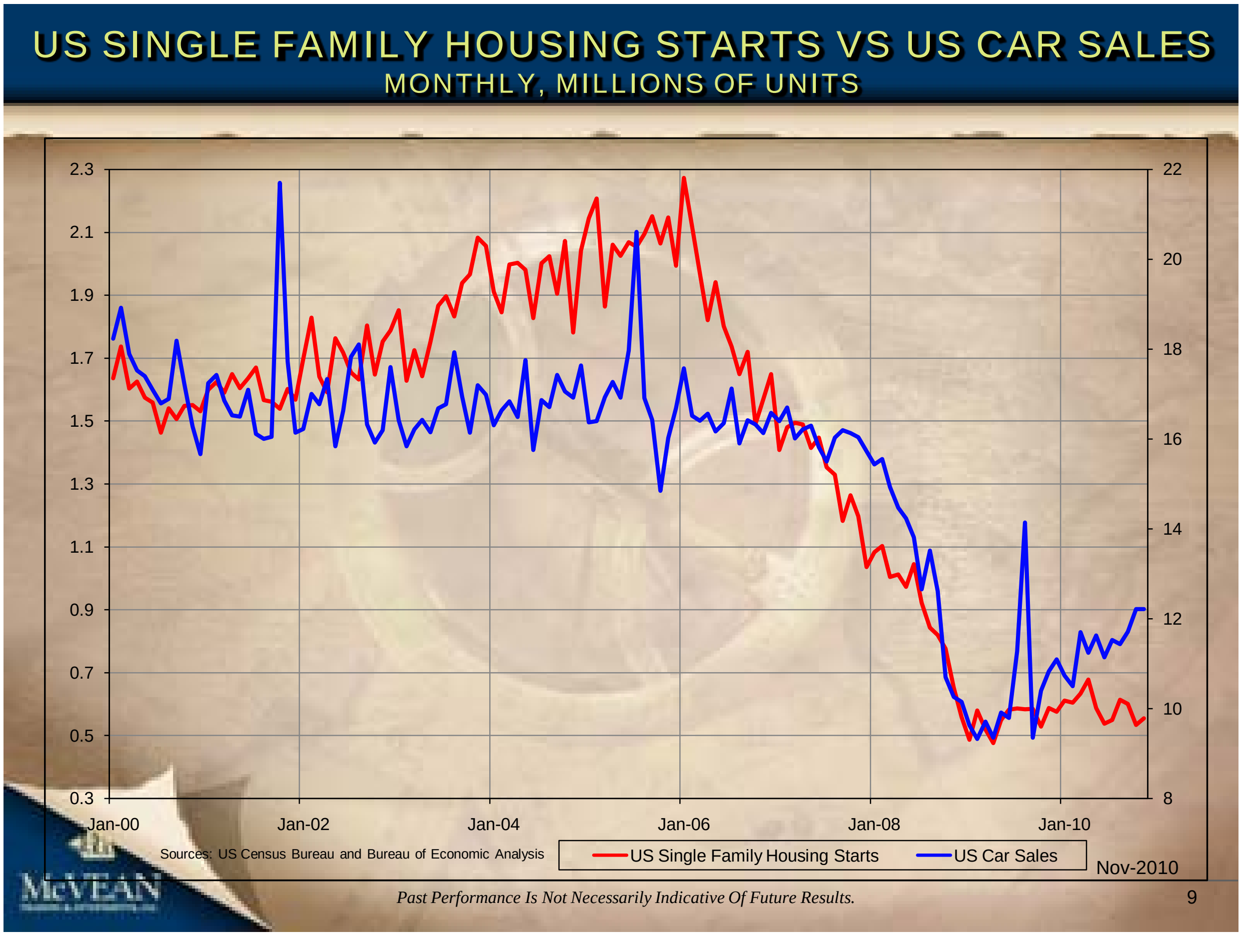
Regardless of the backdrop of general global inflation, the key ongoing shift in relative prices around the world is convergence between the price of cheap developing world labor and expensive developed world labor. As developing nations' incomes rise, their demand is concentrated on goods – more food, more shelter, more appliances and utilities.



This is most apparent in energy prices. The purpose of higher prices is to ration scarce resources – so higher oil prices should force the most inefficient users, like the US, to consume less oil. However, US consumers have decided to make their adjustment elsewhere, by cutting back on eating out or shopping online – effectively reducing their consumption of expensive US labor in the service sector rather than using less commodities.

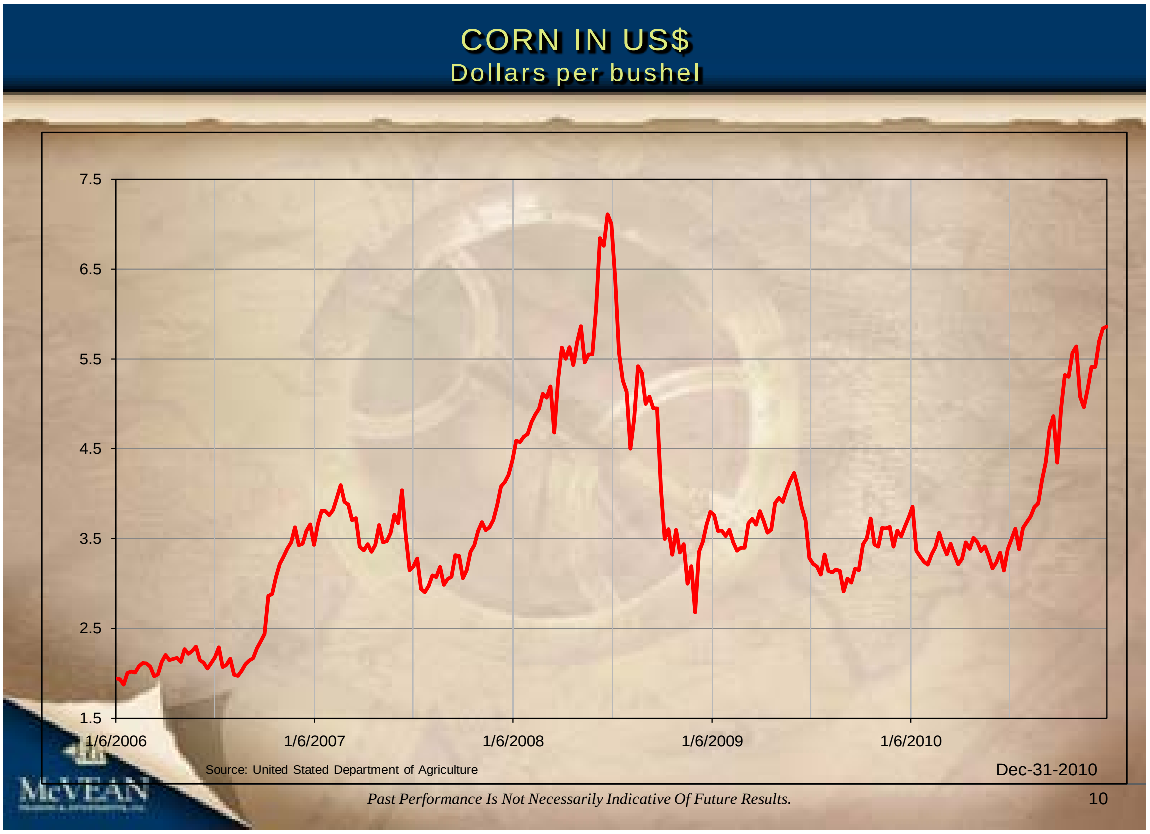


This is most obvious in US goods and service sector inflation. During the rise of China in the early part of this century, cheap Asian labor embedded in imported goods held down US core goods inflation and left more money on the table for service inflation. Today, service inflation has plunged as US labor costs are being squeezed by high unemployment. This puts the burden of the commodities price adjustment on the unfortunate few in the US who have seen their incomes fall – but the safety net in the US limits the income effect even for these households.



Most of the adjustment on the goods side in the US has come in lower demand for interest sensitive durables like homes and automobiles. Housing has high domestic labor content in both materials and labor, exacerbating the problem. The fewer cars now being sold in the US today also have a diminishing domestic content as smaller foreign brands and imported parts are gaining share.

Today, the inflation that is most on the radar is food inflation in China. A series of global weather events have tightened food supplies back to levels not seen since the inflationary 1970s. Even wheat has now seen its larger supply dramatically reduced by the flooding in Queensland, Australia.


CORN IN US$
Dollars per bushel
7.5
6.5
5.5
4.5
3.5
2.5
1.5
1/6/2006
1/6/2007
1/6/2008
1/6/2009
1/6/2010
Source: United Stated Department of Agriculture
Dec-31-2010
Past Performance Is Not Necessarily Indicative Of Future Results.
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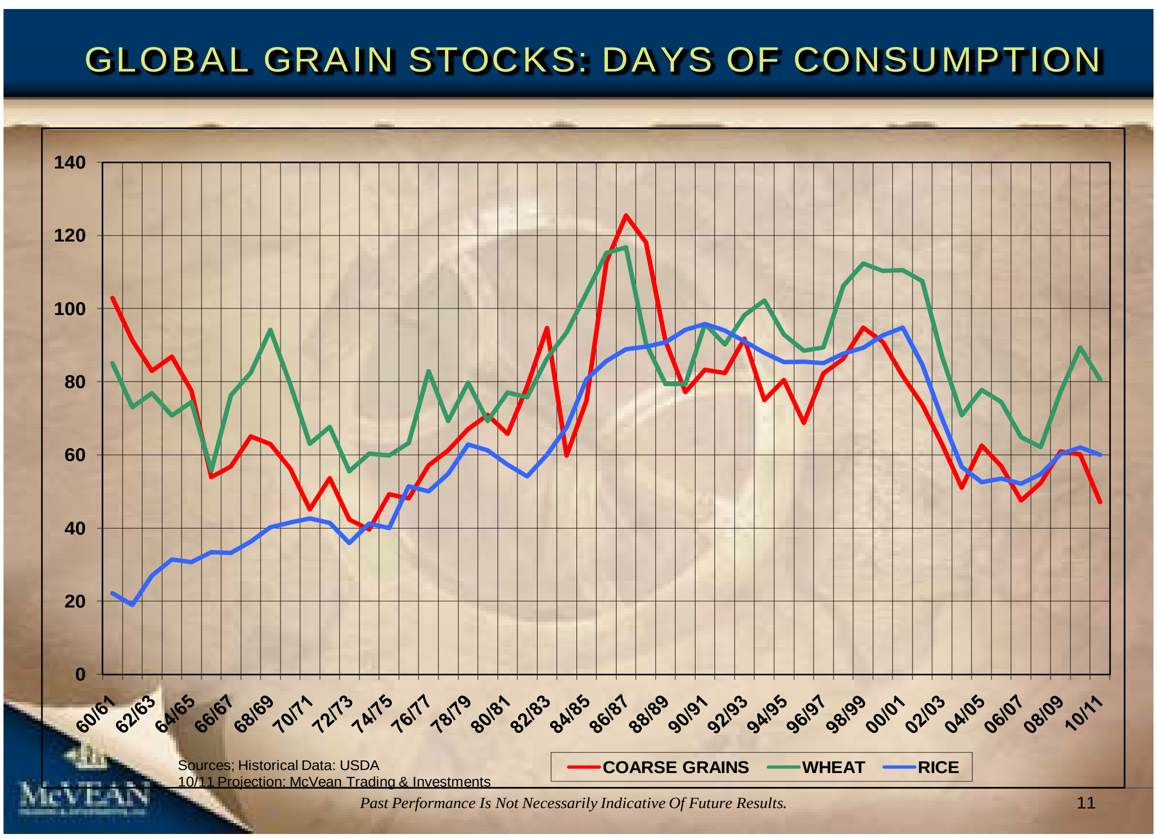
GLOBAL GRAIN STOCKS: DAYS OF CONSUMPTION
140
120
100
80
60
40
20
0
60/61
62/63
64/65
66/67
68/69
70/71
72/73
74/75
76/77
78/79
80/81
82/83
84/85
86/87
88/89
90/91
92/93
94/95
96/97
98/99
00/01
02/03
04/05
06/07
08/09
10/11
Sources; Historical Data: USDA
10/11 Projection: McVean Trading & Investments
COARSE GRAINS
WHEAT
RICE
Past Performance Is Not Necessarily Indicative Of Future Results.
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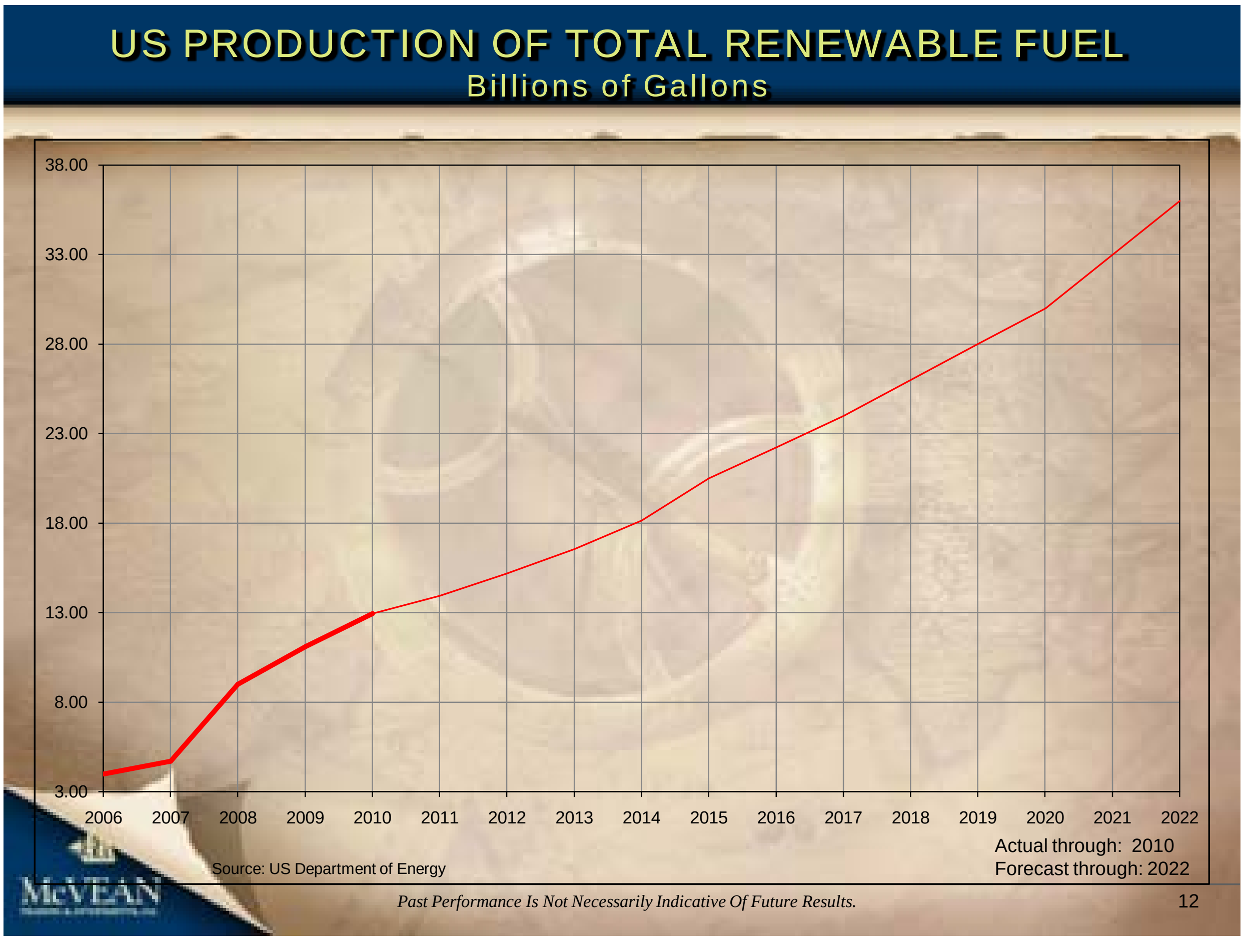
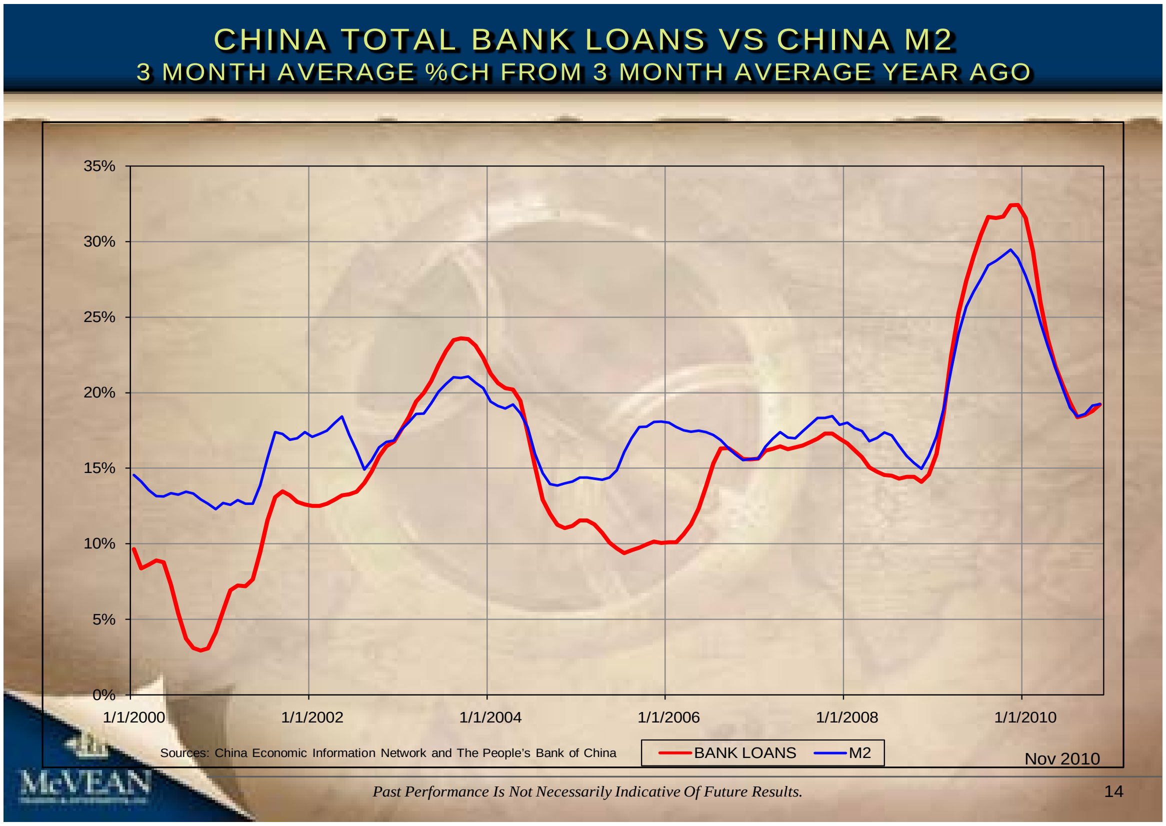
However, the key policy decision behind the current food inflation is the US Congress's ill-advised ongoing support for corn based ethanol. The 2011 ethanol program now mandates that more than one-third of annual US corn production be used to produce roughly 8% of US motor fuel. Though corn acreage planted has grown in recent years in response to this program, the rising price of corn and arable land has also driven up the price of competing crops including soybeans, wheat and cotton. Now the world is faced with tight stocks of all edible grains and oilseeds and little available acreage left around the world. Higher prices are calling for restrictions in demand as supply cannot respond. Given that incomes are rising much faster than inflation in the developing world, the risk remains decidedly on the high side for agricultural prices.



Critically, the inflationary pressure has shifted from the industrial sector to the consumer sector in China. China had suffered from very high inflation as far back as 2005, primarily in construction related materials. However, when US monetary policy eased dramatically after the Lehman crisis, the response was a massive surge in lending in China much of which ended up in inventories of imported commodities. Moreover, the vast majority of the loans went to the State Owned Enterprises and much of it ended up in real estate investments as there was little need for additional industrial capacity in the short run.



CHINA TOTAL BANK LOANS VS CHINA M2
3 MONTH AVERAGE %CH FROM 3 MONTH AVERAGE YEAR AGO
35%
30%
25%
20%
15%
10%
5%
0%
1/1/2000
1/1/2002
1/1/2004
1/1/2006
1/1/2008
1/1/2010
Sources: China Economic Information Network and The People's Bank of China
BANK LOANS
M2
Nov 2010
McVEAN
Past Performance Is Not Necessarily Indicative Of Future Results.
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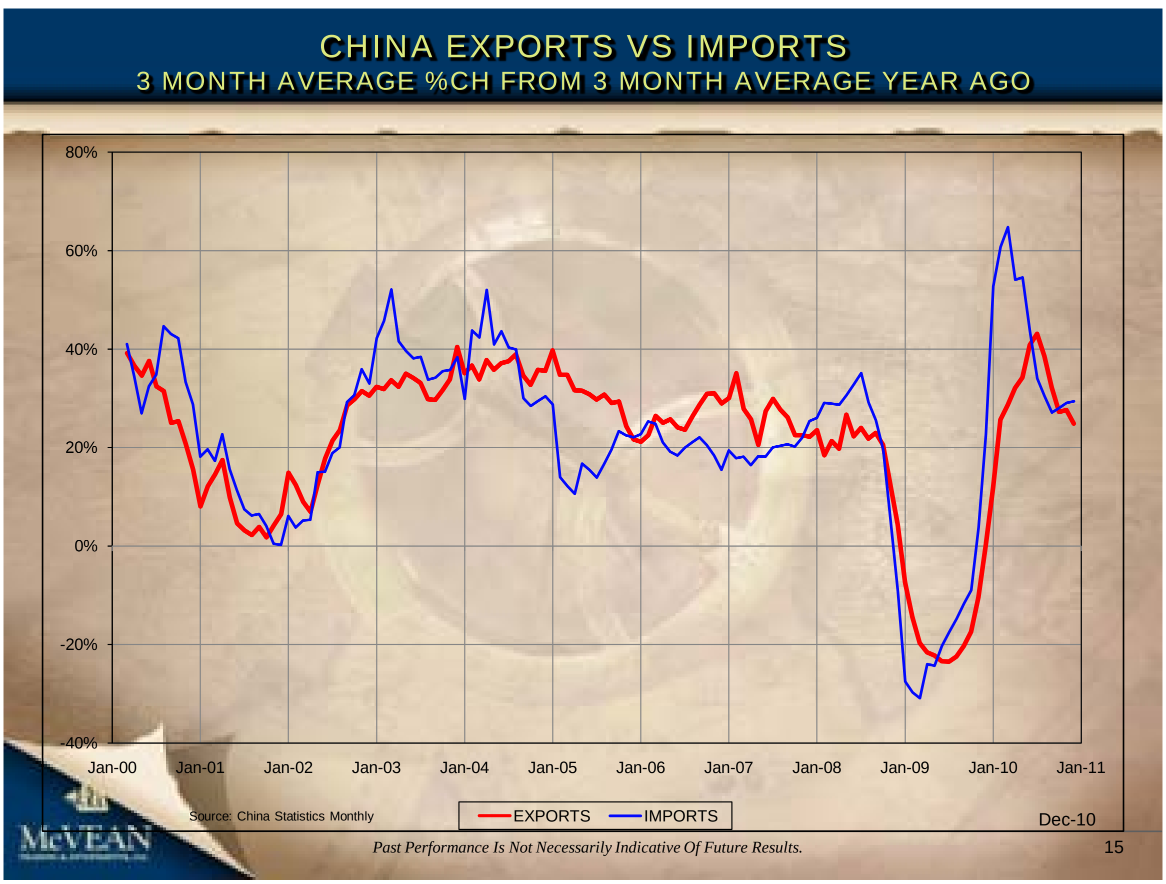

CHINA EXPORTS VS IMPORTS
3 MONTH AVERAGE %CH FROM 3 MONTH AVERAGE YEAR AGO
80%
60%
40%
20%
0%
-20%
-40%
Jan-00
Jan-01
Jan-02
Jan-03
Jan-04
Jan-05
Jan-06
Jan-07
Jan-08
Jan-09
Jan-10
Jan-11
Source: China Statistics Monthly
EXPORTS
IMPORTS
Dec-10
McVEAN
Past Performance Is Not Necessarily Indicative Of Future Results.
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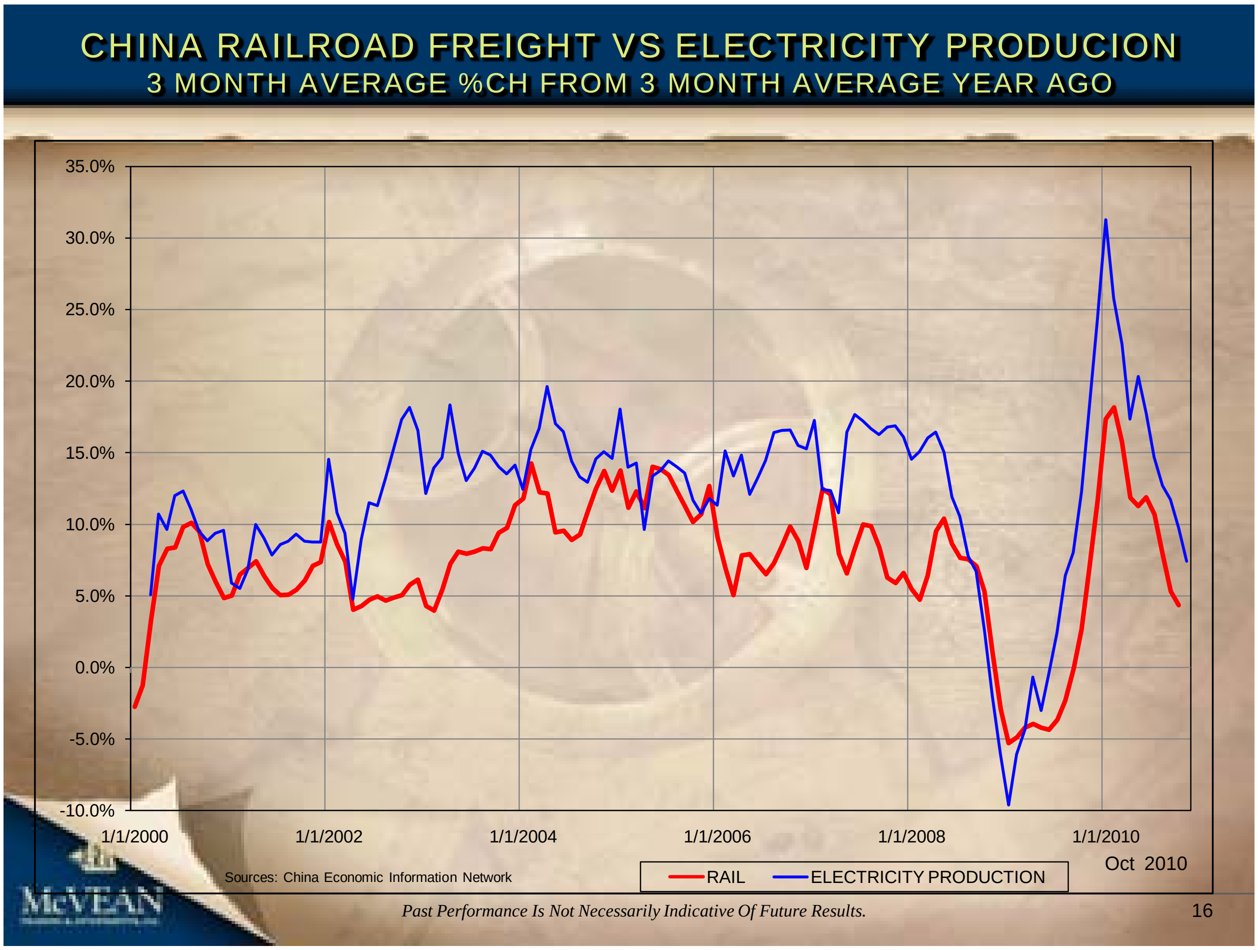
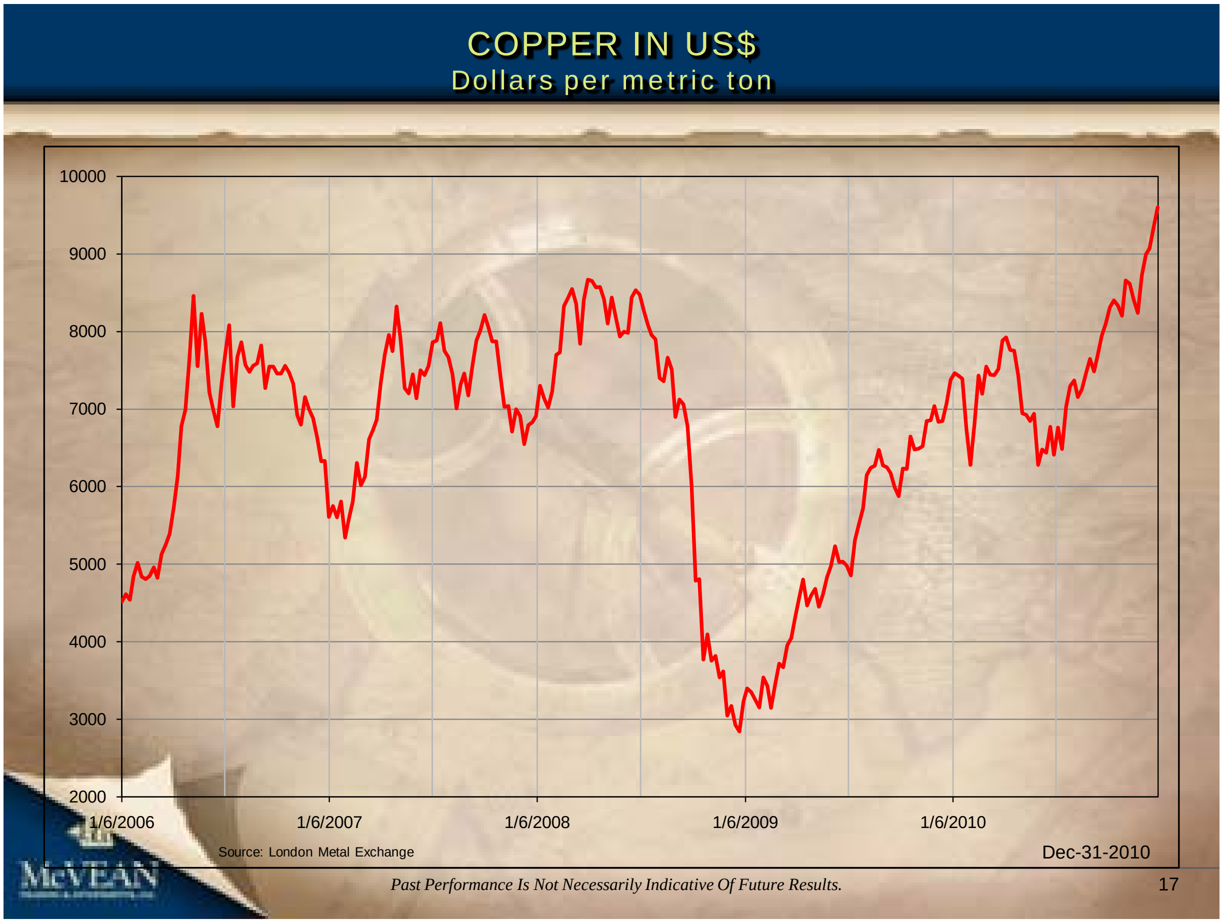
For most of 2010, China has been reining in lending by raising reserve requirements and restricting access to credit. Central government mandates have made it clear that new loans should be directed toward energy saving green technology, low cost housing and agriculture. Loans for real estate projects are being frowned upon. As a result, real estate inflation and associated prices have moderated over the year. Both rail traffic and electricity usage show that the real economy has come off the boil. Indeed, the Chinese government may discover that they have stepped on the brake too hard in late 2010.



This leaves the world in an agricultural commodities trap. The Federal Reserve remains lax on monetary policy because unemployment remains high and core consumer inflation low. The ongoing currency policy in China translates this lax policy into high domestic inflation rather than a stronger yuan. With Chinese domestic lending focused on the consumer, prices of grains and oilseeds, cotton and copper can be expected to outstrip oil, iron ore and domestic construction materials like cement.


COPPER IN US$
Dollars per metric ton
10000
9000
8000
7000
6000
5000
4000
3000
2000
1/6/2006
1/6/2007
1/6/2008
1/6/2009
1/6/2010
Source: London Metal Exchange
Dec-31-2010
McVEAN
Past Performance Is Not Necessarily Indicative Of Future Results.
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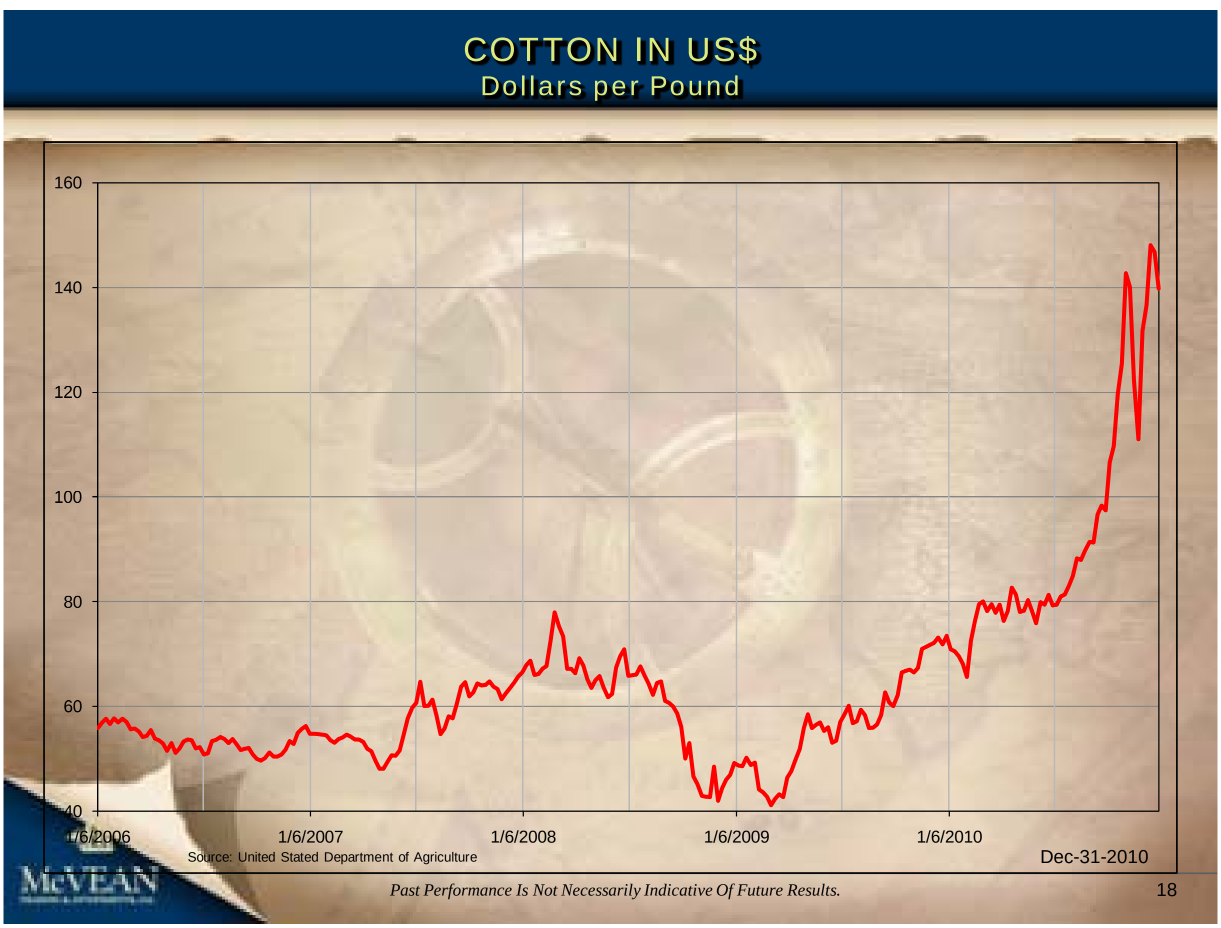
COTTON IN US$
Dollars per Pound
160
140
120
100
80
60
40
1/6/2006
1/6/2007
1/6/2008
1/6/2009
1/6/2010
Source: United Stated Department of Agriculture
Dec-31-2010
McVEAN
Past Performance Is Not Necessarily Indicative Of Future Results.
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Indeed, with real estate investment now frowned upon in China, there is some indication that stockpiling appreciating commodities is the new investment vehicle for excess lending. In the US, this kind of stockpiling would spike prices higher as food is a relatively small market compared to total GDP – but in China, where food still accounts for roughly one-third of all consumer spending, storable foodstuffs are becoming an asset class. This can only exacerbate the food inflation problem globally, without drawing a response from the Fed. Indeed, higher global food and energy inflation actually increase the pressure for lower US service inflation – especially in rents. That reinforces banks fear of falling home prices, restricts their lending -- and so lax Fed monetary policy fails to stimulate money supply growth here as much as in the rest of the world. Bottom line, in this world of excess liquidity the relative price adjustments that are most needed – rising developing world labor relative to developed world labor and rising agricultural commodities costs relative to energy – will happen faster and with greater volatility.