Les Jeux Sont Faits

Wait. Worry.

Oil at over 100 usd is bound to irritate the American SUV driver. When oil was at 147 usd in 2008, inflation was 5% and the world was a wonderful place. Yet we worry now when inflation is 1.6%. A high oil price is, however, a brake on economic growth.

There are complex relationships underlying the single number that characterizes inflation.

Demand outstripping supply is one way to stoke inflation.

Too much money for a given level of real demand chasing too little supply is another.

One cannot help but suspect that at least for the developed nations, who coincidentally form the bulk of the indebted nations, inflation is not such a bad thing. Central banks might conspire to ignite it or at least ignore it.

In emerging markets inflation has reared its head and central banks have been quick to raise interest rates in response.

The US Fed, however, seems content to hold down rates and to print money. Inflation there is a mere 1.6%, aided and abetted by falling house prices and costs of housing which account for over a quarter of the CPI basket. If housing stabilizes, it could place the Fed in a difficult position. For now, this phenomenon provides the Fed with latitude to print and to drive equity and credit markets higher. Until the Fed reverses its policy, equity markets, commodities and oil are likely to keep going higher.

Emerging markets’ fiscal rectitude and hawkish monetary policy have created a correction in their risky assets such as equities, but investors are likely to reward their responsibility once evidence that inflation is under control emerges. It is likely that this will only surface once the Fed starts tightening as well. This is the signal to rotate into emerging market equities.

As an asset class, equities are likely to continue their bull run. Global growth, at least the nominal variety seems supportive. Any pullbacks seem to be driven by responsible monetary policy and represent opportunities to buy. The outlook for bonds is less optimistic. Inflation is unfriendly to fixed income. Only short memories can argue for a the continuation of a 3 decade long bull run in fixed income. The 4 decades preceding Volcker’s inflation fighting crusade were very poor for fixed income.

The wildcard here is Middle East North Africa. The instability seems not to stem from religious or even political fracture but from social and economic pressures, notably along the lines of age on the one hand and orthogonally along the lines of income or wealth inequality.

The catalyst for the unrest is usually unpredictable, which has been the case. For the US the situation is dire. It risks not only energy security but strategic impairment in one of the most important regions in the world. Ironically, its ally and longtime Arab bugbear, Israel, has been reduced to a bewildered and quaking kibbitzer in this insane game.

There is the risk that the revolutions in Egypt and Tunisia spread to the rest of MENA. There is no good analogue. The fall of Communism in the late Eighties also left a clutch of countries irrevocably changed. The vacuum that Communism left behind was filled not with democracy or capitalism but chaos. MENA could go the same way. It is unclear what the Arab Street wants, although it is quite clear what it doesn’t want. Freedom and self determination are laudable ideals but not a sufficiently defined blueprint for nation building. Nature abhors a vacuum and tends to fill it with anarchy and chaos.

The risk of more failed states arising is high.

Long term instability in MENA may encourage hoarding and further drive up the prices of commodities. A chronically high oil price while not catastrophic will act as a tax on global trade. The inflation rate associated with a given level of global output must rise.

It is hard to predict how the instability in MENA will unfold and it is futile to speculate on the repercussions to unpredictable events. One can only wait and see and react to the situation as it unfolds.

In the meantime we are nervously long the market with a tight stop and a tricky trigger finger.