

Is Inflation Really Down and Out?

Financial markets have recently shrugged off inflation concerns. Our survey of GS equity research analysts shows that input cost pressures have been muted since the start of the year, that companies' pricing power is limited, and that it is likely to remain contained over the next six months. This is consistent with our core views on inflation.

Benign price data and the pullback in energy prices since mid-August seem to have put the inflation scare of the early summer to rest and bolstered hopes that inflation will remain under control. The significant drop in market-based measures of inflationary expectations is visible in the inflation swap markets and in the spread between nominal yields on 10-year Treasuries and their TIPS-based counterpart.

Yet there are lingering fears that inflation will make a comeback. Most centre on the US, where the tightening of the labour market and the steady erosion of productive capacity have led to a rise in unit labour costs. This suggests that core inflation, which at 2.8% is already well above the Fed's implicit 2% target, could continue to accelerate in the months ahead.

An important aspect of the inflation debate is the question of whether, and to what extent, pricing power is returning. To assess this, we have polled our industry analysts across the

US, Europe and Asia. The outlook from a bottom-up perspective is reassuring, supporting our own view that global inflation is likely to remain under control at the consumer level.

Input price increases appear to have been relatively muted despite the run-up in commodity prices earlier this year. The impact of commodity price increases has also outstripped wage pressures, suggesting that the commodities reversal—if sustained—will ease what stress does exist. Most importantly, companies' ability to pass on price increases to end-users is modest, and half the market globally does not expect this to improve over the next six months.

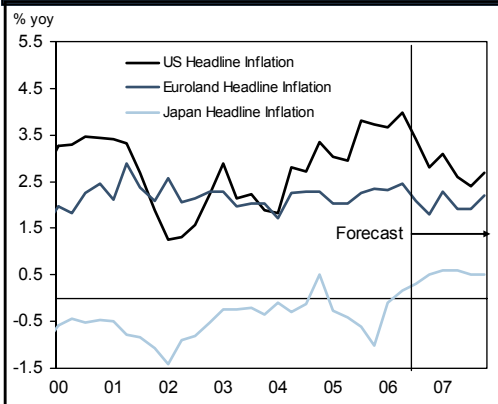
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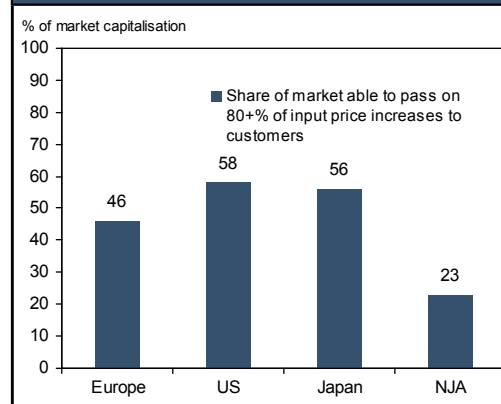
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Subdued Headline Inflation Going Forward



Pricing Power Strongest in US, Weakest in Non-Japan Asia



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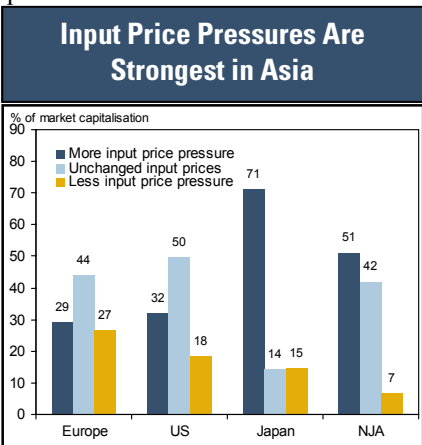
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Survey Says . . . Pricing Power Is Muted

How well does the view from the bottom match our outlook from the top? With nearly 150 responses from the GS equity analysts in US, Europe and Asia, our survey of pricing power gives an unusually comprehensive bottom-up look at ongoing inflation dynamics. We have weighted the results by market capitalisation in order to see the dynamics driving the market as a whole.

On the whole, the results suggest that inflation should remain well-contained for at least a while longer—particularly if commodity costs continue to fall or even stabilise.

Input price increases have been more modest than we might have anticipated. Globally, less than 40% of the market has felt increased input cost pressure since the start of the year. A slightly larger share indicates that cost pressures are unchanged, while 20% reports that they have actually fallen. The worst-affected sectors are Oil and Gas (overwhelmingly) and Cyclical and Defensives (less so). But the picture is not uniform: nearly half of the Cyclical sector reports that input prices have fallen.



On a regional basis, Asia has borne the brunt of higher costs. Half the market in Non-Japan Asia (NJA) and 70% of the market in Japan indicate that input prices have risen since January.

In contrast, the US and Europe appear relatively well-protected thus far. Only 30% of these markets report higher input prices since the start of the year; half say that pressure is unchanged; and somewhat surprisingly, 20%-25% indicate that pricing pressures have actually fallen over the course of 2006.

Commodity prices are cited as a key factor driving up costs. The pressure is particularly acute in Europe, where close to half the market flag commodities as the key factor, compared with roughly one-third in the US and Japan. In NJA, however, capital spending is seen as the most important factor.

The importance of commodity prices is also visible in the sectoral breakdown. Only the Oil and Gas sector reports increased price pressure (though overwhelmingly so). Pressures are ‘unchanged’ in Defensives (64%), TMT (70%) and Financials (80%), while nearly half of the Cyclical sector says that input prices have fallen. Given that commodity prices are cited as the largest component of the cost base for both Cyclical and Defensives, this suggests that cost pressures in other areas (including wages and capital spending) have been remarkably mild.

Are firms able to pass on price increases? Generally yes, although not as much as they might like. Globally, roughly half the market can pass on the bulk (80% or more) of input price increases. But one-third is only able to pass on a small fraction of any increase. Across the G3, there

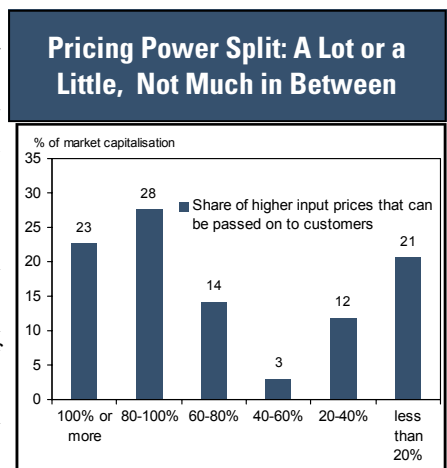
seems to be very little ‘middle ground’, with the results clustered in the 80+% range and at the bottom (less than 40%).

On a regional basis, the US and Japan are somewhat stronger than Europe. Pricing power is notably weak in NJA, where only a quarter of the market is able to pass on the bulk of increased input prices, and 40% cannot pass on any.

By sector, Financials and Oil have the greatest pricing power, and TMT the least, according to our survey. Analysts report that competitive pressures are the main reason why some sectors, notably Cyclical, Defensives and TMT, have little pricing power. The most common explanation is that end-users are accustomed to price deflation and are unwilling to absorb price increases, forcing producers to absorb higher costs into their margins.

Softening demand does not appear to be a major issue: only 5% of the market overall, largely concentrated in Cyclical, cited this as the key explanation for weak pricing power.

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Globally, the market is evenly split on the **six-month outlook**: 51% expect to be ‘more able’ to pass on price increases to their end-users. US and Japanese analysts are the most optimistic: two-thirds of the US market and nearly 60% of the Japanese market anticipate increased pricing power.

In Europe, the market is more or less evenly split. The current lack of pricing power in NJA looks set to continue, with 70% of the market likely to be forced to absorb the incremental costs. The sectoral outlook is also unlikely to change, with Oil expected to enjoy the most pricing power and TMT the least.

Among the G3, European **profit margins** look most vulnerable to any swing in commodity prices. Commodities are reported as the biggest driver of costs in Europe, where a good share of the market is already unable to pass on much of the

increase. Less than half the market expect to be in a better position in six months’ time. The US appears better protected by nature of the fact that wages are a much more significant cost driver than commodity prices, and because two-thirds of the market expect greater pricing power in coming months.

The issue to watch here is unit labour cost data, which rose sharply in the first half of the year. For now at least, the market seems to be ascribing this increase to year-end bonuses rather than to ongoing wage increases. In Japan, commodities are an important factor but not the leading one (the high score for ‘other’ makes it difficult to pinpoint the area of greatest vulnerability).

NJA profit margins look vulnerable. Input prices have risen (more significantly than in the US or Europe); it has the least pricing power across the four regions; and expectations for improvement are the lowest. Intriguingly, NJA analysts are

the least concerned of all regions about the risk from commodities prices. Our own view, however, would be that NJA is still susceptible to commodity price shocks. Capital spending decisions, and prices, will reflect commodity prices. And Chinese growth is an important top-line driver for much of the region. If commodity prices weigh on growth there, then the rest of Asia is likely to suffer.

How Does the Survey Mesh With Our Views?

The results of the survey are broadly consistent with our expectation that global inflation is likely to remain well-behaved over at least the next six months. Our survey has suggested that strong competitive pressures have generally required firms to absorb cost increases into their (elevated) profit margins and therefore limited their ability to raise prices.

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Our survey did not point to slowing demand as a factor behind the modest pricing power. But this could become a bigger issue going forward, given our forecast of a gradual slowdown in global demand over the next year. Put simply, weaker demand and more slack (or at least less pressure on capacity) could make it even harder for companies to begin raising prices.

In the US, our analysts report that wage increases have been the biggest driver of cost pressure and that firms will be more able to pass on these cost pressures to end-users going forward. We agree that rising unit labour costs could keep inflation sticky at an elevated level for some months to come. But we are less convinced that firms will be able to pass these costs on to the consumers.

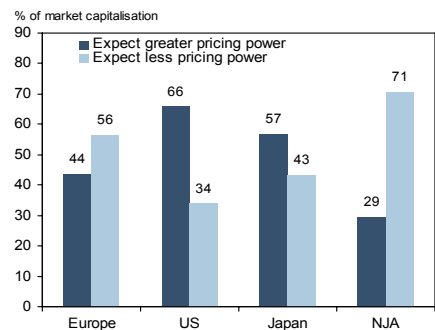
Our baseline view—which seems to be shared by the Fed’s staff—is that the economic slowdown, driven by weaker consumer spending, will ease capacity constraints and lead to a decline in inflation during 2007. Coupled with a favourable base effect from petrol prices, we forecast headline inflation will fall from an average 3.5%yoy this year to 2.7% in

2007. Core inflation should fall gradually and move below 2.5% by the end of 2007. Further out, we see headline inflation stabilising in the 2.0%-2.5% range.

The survey results also fit with our views on European and Japanese inflation. In Europe, the apparent lack of pricing power helps to explain why inflation has remained low in the face of rising commodity costs. The survey also confirms that wage pressure remains subdued and that this is likely to remain true even if the labour market continues to improve. Our latest projections for the Eurozone show headline CPI inflation at 2.2% in 2006 and 2.1% in 2007.

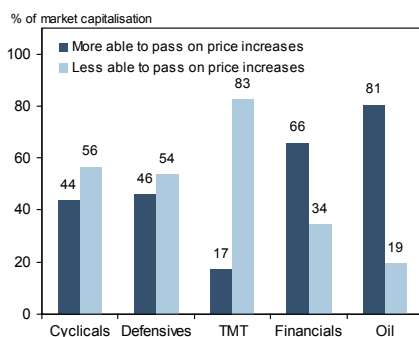
By contrast, in Japan, analysts remain optimistic that pricing power will increase. This supports our view that headline inflation will pick up to an average of around 0.5%-0.6% over the next two years, as increased demand and above-trend economic growth (despite what we see as a temporary slowdown at the moment) continue to exert upward pressure on nominal wages. If the recovery continues in the way we expect, Japanese companies should be more comfortable about passing on input cost increases than in the past.

Mixed Expectations for Pricing Power Over Next Six Months



- **Labour costs.** Rising unit labour costs are a near-term risk, particularly in the US, but also in Europe, where the labour market is beginning to tighten.
- **Strong US growth.** Given the limited amount of spare capacity in the global economy, there would be clear inflationary consequences if the US economy regained momentum next year—against our expectations—at a time when growth elsewhere remained steady.

Only Oil and Financials Enjoy Strong Pricing Power This Year



As Always, There Are Risks

While prospects for a gradual decline in inflation look encouraging, there are, as always, a number of risks.

- **Commodity prices.** Our survey underscores the risks of a supply shock, particularly in energy. Even without a shock, the continued strength in the Chinese economy means that the recent pullback in energy and commodity prices could be temporary.

- **Imported inflation from Asia.** Although our survey shows that NJA firms do not have much pricing power now, the increased input price pressure that they currently face could pose a risk to the US and Europe in the future. On the whole, however, we think the global economy should continue to benefit from the disinflationary forces of globalisation, spurred by the rise of the BRICs and the emerging ‘Next 11’ economies.

Thanks to Binit Patel, Georgina Taylor and the GS Equity Research Strategists.