

## World Overview

**Growth:** Data revisions confirmed strong growth in the UK in Q3 (3.2% y-o-y). This seems to have continued into the 4<sup>th</sup> quarter with retail sales up 3.1% y-o-y in November. This won't continue: fuel and food price inflation as well as increased mortgage payments are hitting household budgets and house prices are falling. The Eurozone also experienced above trend growth in Q3 (2.6% y-o-y) but business and consumer confidence has been falling for six months and this may lead to weaker spending from now on. We expect growth to slip to around 2% in 2008. Q3 growth in the US was revised up to 4.9% (q-o-q annualised) but here the outlook is much weaker. Business and consumer confidence has fallen sharply and growth will struggle to be above 1% in Q4 with a very modest upturn in 2008.

**Inflation:** UK inflation rose to 2.1% (y-o-y) from 1.8%. Whilst this is on target, food and petrol prices are rising much faster as is the cost of inputs to factories. The Eurozone is similar: whilst core CPI is at 1.9%, headline CPI has been pushed to 2.6% by rising food and petrol prices. However in the US, inflation, current and forward, seems to have eased. Chinese inflation of 6.5% is problematic in all sorts of ways though Japan, with inflation of 0.1% remains locked in a struggle against deflation.

**Policy:** After a 25 bps cut in December UK interest rates at 5.5% are still above their neutral rate. Notwithstanding some inflation worries we expect further reductions in 2008. Euro zone rates are less likely to fall in the near term due to strong money growth and a tight labour market. With risks very much on the downside and inflation stable we expect the US Fed Funds rate to be 4% by February from 4.5% now. A substantive revaluation of the Chinese Yuan cannot be far way.

## Region by Region (changes in bold)

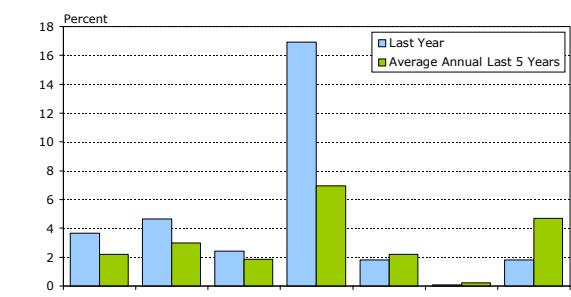
	Growth	Inflation Rate	Short Int Rate
USA	Weakening	<b>Easing</b>	<b>Falling</b>
Euro zone	Weakening	Steady	Stable
UK	Weakening	Steady	<b>Falling</b>
Japan	Weakening	<b>Steady</b>	Stable
Canada	Strong	Steady	<b>Falling</b>
China	Strong	Rising	Rising
Australia	Strong	Steady	Rising

## Are food prices driving inflation up?

An important theme in recent press coverage of economics has been the impact of rising food prices on inflation. Articles have ranged from the implications of climate change for food production to the rising cost of a Christmas lunch. We consider the potential implications for real estate. The world is in the grip of a credit crisis: the only respite in the offing is cuts in interest rates. If central banks consider inflationary pressures too pervasive these cuts will be delayed.

Chart 1 shows the scale of the problem. The UK and US are suffering substantially higher food price inflation this year, compared to the last five. In Australia, following five years of high food inflation recent trends appear improved, although the current drought may well bring problems next year. China is the country suffering the most rapid increases in food prices. In addition to the painful impact this has on

Chart 1: Food price inflation



Source: Global Insight

low income groups there are substantive macro-economic consequences.

Headline inflation is measured by calculating the price changes of a representative 'basket' of goods. The 'basket' is created from the results of surveys into how households spend their money. In countries with lower per capita incomes households spend a higher proportion of their income on food so, food has a higher weighting in measures of inflation. In the case of the UK, US and Euro Area, the weighting is quite low (Table 1), so food price growth only creates a small impetus to inflation. Australia's food weighting is low but the persistent increase in food prices over the last few years will have had an impact. The country, with the greatest potential feed through from food to general inflation, is China, where the CPI food weight is 35%. So far the impact has been limited because the prices of other goods in the CPI basket, such as clothing and footwear, are falling. However, China's inflation is at an eleven year high of 6.5% and the issue has become a top concern for the Chinese government. Persistent inflationary pressures may feed into demands for higher wages which would signal the end of the era of cheap goods for the rest of the world and potentially China's export led expansion.

**Table 1: Importance of food in national inflation (CPI) measures**

	Food	Food and alcohol
UK	9%	10%
USA	14%	15%
Australia	15%	22%
China	34%	
Japan	26%	
Euro Zone	14%	15%
Canada	18%	22.50%

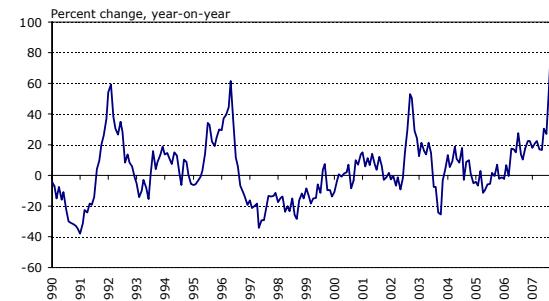
What are the causes of the hike in food prices? A variety of factors affect each food type but we focus on wheat prices (Chart 2). As well as being a staple, wheat is also a major component of animal feed so contributes significantly to the cost of producing eggs, meat and poultry. The correlation between wheat prices and those of eggs and feed is 0.6 and 0.7 respectively. The series is volatile, because, as with real estate, supply cannot respond to demand in the short-term. The recent very substantial hike in prices has been linked, by some, to the transfer of production from food to bio-fuel. We think this unlikely: bio fuels currently cover 10 million hectares compared to a total global cropped area of 1.5bn hectares. A series of weather related bad harvests in the main producing countries are the real cause: the drought in Australia (the world's third biggest producer), wet weather in Canada and Europe all reducing output by 10-20%. The chart shows something of an upward trend in price changes since about 1998. This is likely to be driven by strong economic growth in previously poor countries. Is climate change an issue? It's probably too early to say, though some would draw the link between weather related poor harvests and CO2 emissions.

How will this impact on real estate? Inflation in China is a long term worry because low production costs are the basis of the current economic expansion in the region and elsewhere. Beyond this, food prices are making a contribution to general inflation in the west, but they are probably not sufficiently important on their own to derail imminent interest rate cuts except in Europe given the fear of some ECB members that inflation has become "alarming"; driven by energy, food prices and wages. Longer-term there is likely to be an expansion of wheat production leading to price falls next harvest.

In the UK, the immediate future may not be so comforting. Chart 3 shows an economic indicator created for the UK but applies, at least in general terms, to other western countries: the Christmas lunch and full English breakfast index. The cost of these two meals is rising much more quickly than general inflation. Since UK consumers are also feeling the pinch from increases in utility bills and mortgage rates they may well decide that they cannot allocate as much to gifts, clothing and other household goods this festive period. This points, potentially, to a lean Christmas for high streets and malls.

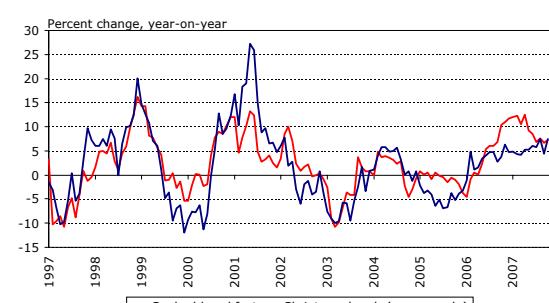
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**Chart 2: Wheat prices**



Source: Global Insight

**Chart 3: The cost of breakfast and lunch**



Source: ONS, Global Insight, Grosvenor Research