

The Virtuous Inflation
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We know this is an odd thing to ask as oil reaches \$143 a barrel, but nonetheless: Is there such a thing as a virtuous inflation? We will try to convince you of two propositions: First, the movement to higher prices for oil, corn, steel, iron ore and many other commodities is, we believe, a secular and permanent event, caused not by speculation but by increased global demand. Second, the causes of this inflation are basically benign, and you ought to be happy about it, for reasons both altruistic and self-interested.

In the past year, oil prices are up 97%, corn up 124%, natural gas up 93%, gasoline up 57%, gold up 40%. Most people's first reaction is a fear that we are returning to the 1970s. But this is not your father's inflation. It's different, because the inflation of the 1970s was *supply* driven. OPEC's short-lived embargo of oil to the West caused immediate price increases, and even after supply returned to normal, the market continued to reflect fear of future supply disruptions. The current inflation is *demand* driven, and is mainly caused by inexorable global economic growth. Put simply, we estimate that between 800 million and 1.5 billion people have been making a transition from poverty to the very lowest rungs of the working classes. The global dimensions are complex, but on an individual level the concept is straightforward: Before, they ate solely beans or rice; now they eat chicken or pork occasionally. Grain needs soar, as it takes four pounds of grain for every pound of meat produced. Before, they lived a subsistence, agricultural living; now they toil in a factory and earn enough to send a child to school. Steel, electricity and concrete prices rise as factories are built, and the surrounding cities are created from nothing. Before, they rode bicycles; now they have a beat-up used car. Fuel needs surge. Each incremental person adds only the slightest bit to demand. But it is our belief there are more than a billion people making this transition, aided by governments in China, India and elsewhere that are eager to stoke a wealth-producing trend.

From a moral standpoint, poverty reduction is obviously a good thing, though we don't want to leave the impression that we have reached some sort of utopian ideal. Massive populations now have a chance to work very hard to start climbing out of poverty, rather than remaining on the endless treadmill of subsistence living, disease and famine. From an economic standpoint, the evidence is overwhelming. The car population of China is *twice* what it was five years ago and up *ten-fold* from 1994. China in 2006 consumed less than 2 barrels of oil per person, Mexico 7 barrels, and the U.S., 25. Yet, if one assumes the current pace of oil consumption growth in China will continue (from 1990 through 2006 it grew at 7.2% per annum), it will be using as much oil as the U.S. is today within 12 years. The rates of growth are almost as high not only in India, but for Brazil, Russia and Eastern Europe as well.

We know that this global rising tide will have its ebbs and flows. But we do think this is *a secular and not a cyclical event*. To put it in pragmatic terms, no amount of offshore drilling in the United States or Saudi spigot-turning is going to drive oil prices back down to where they were a couple of years ago.¹ For perfectly wonderful reasons - a reduction of poverty produced by a rising tide of global development -- we have entered a world where more mouths, cars and electric grids will be competing for the same resources. Those of us of a certain age used to collect UNICEF donations on Halloween. Many of the ultimate recipients of those donations in countries like China, Brazil and Vietnam now have children who are helping to drive up the price of oil, corn and copper. It's hard to get too upset about that.

These days, there is a growing argument about whether the rise in commodity prices is primarily due to growing worldwide demand or to speculators in the commodity pits of Chicago, New York and London. While it would be foolish to dismiss the role of speculators, and clearly prices of commodities on the future markets show signs of being jerked to and fro on a short term basis, we believe there are several reasons to side with supply and demand dynamics and not excessive speculation as the cause of our current inflation.

First, if you believe speculation is setting the price above what natural global demand would require, some buyers would step back. By definition, an “artificially” high price set by speculators would exceed the marginal buyer’s appetite. Since the speculators do not take delivery of oil – in the evil-speculator-conspiracy theory, they merely buy and sell oil futures – and, since they have manipulated the price high enough to inhibit demand, stock piles of the actual underlying commodity should start to build. But supplies of oil remain extremely tight. There is no evidence that supply and demand are out of whack – in fact, the ‘invisible hand’ of the marketplace seems to be working just fine. The market is raising its price for the slowly-growing supply of oil due to the more-quickly-growing demand. Inventories are being cleared in an orderly fashion, showing little sign of speculative excess.

Second, we can look at a few commodities that speculators couldn’t buy and sell, even if they wanted to manipulate them. Iron ore is the initial mineral from which steel is produced. As construction expands in the developing world, steel usage has surged. Iron ore does not trade on an exchange, so “villainous” hedge fund managers can’t manipulate iron ore futures. The price is set annually in private deals between large iron ore miners and large steel companies, mostly in Asia. This year that price jumped over 90%, its fourth consecutive double-digit increase, and it’s largest yet.

The point is not that oil should be \$150 or \$200 or \$100 a barrel. The broader point is simply that demand is steadily creeping higher while supplies are limited, and the

¹ Name the country that produces almost exactly twice as much oil as Iran. It is, of course, the United States, which consumes all of its own production plus requires an additional 60% of its oil to come from imports. We can probably add incrementally to our supplies by drilling offshore or in Alaska, but as world economic growth continues, we believe that such production additions, coming on line years from now, will not begin to reverse the rise in the price of oil.

sooner we stop trying to blame bogeymen (whether speculators, cartels or Dick Cheney) and start embracing a brave new world of scarcity, the better off we'll be. We wouldn't be surprised if oil prices took a (well-earned) breather. They could drop, say, \$40 a barrel (the equivalent of the price of *an entire barrel* four years ago) due to short term market movements. (And when that happens we can blame the temporary crash all on speculators.) But such a decline would merely put prices back to where they were *three* months ago. Our argument is simply that the *long-term trend* is and will be in favor of higher prices, based on demand/supply imbalances.

It's hard to see this trend reversing, absent a severe global economic downturn. The way to respond to increasing demand without producing inflation is to increase supply. That can happen over time more easily in some areas than others. More grain fields can be planted -- and certainly will be planted, with grain prices at record highs. Advances in agricultural science like better seeds and pesticides are also making each acre more prolific. But energy feedstocks, especially oil, are more difficult commodities to produce in ever greater amounts. Oil production, while still increasing worldwide, is growing at an ever slower rate, and it is certainly not keeping up with the rate of demand growth. When one examines the anticipated rate of growth in energy consumption from the developing world, and compares it to the anemic (not to mention ever-more-expensive) sources of increased production, we think the only conclusion that can be drawn is that substantially higher oil prices are here to stay. Furthermore, absent massive new discoveries, the prices for copper, iron ore, uranium, and many other important industrial materials could also remain elevated for the long term.

Now, even if you buy the fact that prices of gasoline, corn meal and steel are higher because the world's poor are becoming middle class, and even if you view that as a wonderful thing, you still might not feel warm and fuzzy when you're refilling your tank. We won't try to make you feel warm and fuzzy, but we do want to put forth two reasons why this rising global tide is not merely a zero sum game, and that there are benefits for us that might outweigh (or at least partially offset) the current negative effects of inflation.

First, if we are anywhere near right about the 800 million to 1.5 billion new entrants to the lower middle class, they represent a tremendous new market for goods and services that can help offset slower growth in the developed world. Soon they will buy hamburgers from McDonalds, watch movies from Hollywood and use electricity generated by General Electric turbines. Eventually they will buy copies of Microsoft Office and fly in Boeing aircraft. This is admittedly a long-term proposition, but it is powerful nonetheless.

Second, more proximately, the U.S. is in a severe credit crisis due to the inflation and subsequent deflation of residential home prices. This is a heavy drag on our financial system and overall economy. The growth of regions outside the U.S. should help to offset some of this slowdown. Sure, our economic troubles will slow everyone down, but the old saying "if the U.S. sneezes, the world catches a cold" is no longer true. In 2001, the U.S. entered a recession, and for the first time in the post-war period, most of Europe

(including England) and Asia did *not* follow. The global economic tide will rise less quickly if U.S. growth recedes, but, critically, it should continue to climb. And that should be a mitigating factor here in the midst of our mortgage-related woes.

Inflation, that bogeyman of the 1970s, is not altogether horrible or unexpected when it is caused by growing worldwide affluence. It is merely a symptom -- a growing pain -- of a world that needs to find solutions to the challenge of feeding, transporting and illuminating (both figuratively and literally) more people than ever before. We believe, in the long run, increased world living standards can lead to many more opportunities than shortcomings. More importantly, however, if this thesis is correct, there is nothing to hold back the rising tide. Even if you malevolently wanted to stop the rising affluence to halt inflation, there is no genie to put back in the bottle. There is a new world arising, and it requires an understanding that things truly are different this time.

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