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Recovery May See Producers Pass On Commodity-Price Inflation

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Roaring commodity prices fueled inflationary pressures in the developing world last year, even as many developed nations fretted about deflation. But as 2011 starts off with stronger economic data in the U.S. and other advanced nations, signs point to a cautious return of pricing power there as well.

Commodities logged some of 2010’s strongest gains as strong demand for crops and materials in developing countries — coupled with a flood of monetary liquidity into the global economy from the Federal Reserve and other developed country central banks — prompted investors to buy everything from soy beans to copper futures. This anticipatory buying helped palladium, which is used in car parts, to gain 96.5% while cotton broke its Civil War record with a 91.5% price increase.

These higher prices manifested in rampant inflation in many parts of the developing world, where robust economic growth is helping a new class of consumers discover the material comforts that developed country consumers are accustomed to. New coffee drinkers in Brazil and China, for instance, helped augment existing demand to lift bean prices 77% last year.

“A buzz word has been the new middle-income class, not from the U.S. or Europe but from China, India and Brazil,” said Yu-Dee Chang, chief principal at ACE Investment Strategists, with around $130 million under management. “They’ve never had a TV or a car so as they’re spending their new wealth they trigger inflation.”

Global food prices rose to a record in December, with the Food and Agriculture Organization of the United Nations’s food price index reporting its sixth straight monthly increase to 214.7. The index tracks monthly changes in international prices of a basket of commodities including meat, dairy, cereals, oils and sugar.

Some developing countries, where one third to one half of the average income is spent on food, are already feeling the political pressure of rising food inflation. In China, the government reined in credit availability and hiked interest rates after double-digit leaps in food prices awakened concerns about economic stability.

Yet fears of runaway price gains caused by the Fed’s loose monetary policy, which pushed inflation hedges like gold to a closing record of $1,421.40 per troy ounce in December, failed to materialize. Three years of economic downturn in the developed world left spending so weak that businesses had to cut prices to attract customers, making deflation a far bigger concern for policymakers than inflation.

Now, that trend could be ending. U.S. retailers, for instance, were able to avoid deep discounting this past holiday season. And in coming months, stronger U.S. growth may finally let companies pass higher costs to consumers and start the upswing in the inflation cycle.

A gangbusters U.S. report on private sector jobs growth Wednesday was the latest indicator of brighter economic times ahead. Meanwhile, Germany’s economy is growing strongly and even the sickly U.K. is seeing a recovery in manufacturing.

A growth acceleration is very likely in 2011, says Lakshman Achuthan, managing director of the Economic Cycle Research Institute, which publishes the closely watched Weekly Leading Indicators. The WLI has been signaling a revival in economic growth.

Achuthan says the WLI has been showing faster growth from private-sector sources well before the Fed's $600 billion fiscal stimulus or Washington passed the 2011 tax-cut package. As a result, U.S. demand should get a triple boost this year, and growth should be robust enough to let price increases stick.

The ECRI's leading inflation gauge indicates that inflation is edging up — although not to worrisome levels. Similarly, a rise in yields on longer-dated Treasurys over the past month is thought to reflect a pickup in investors' inflation expectations.

U.S. companies will welcome the opportunity to charge more because they have so far been absorbing higher input costs. The latest prices-paid indexes from the Institute for Supply Management increased in December.

Indeed, businesses are already expecting to mark up their price lists this year. VF Corp., which makes Lee and Wrangler jeans, and Hanesbrands Inc. have said they will raise apparel prices in 2011 to offset higher cotton prices. A survey released last week by the Kansas City Fed showed that a rising number of regional manufacturers anticipate passing along higher costs to their customers.

If higher commodities prices do trigger a small but manageable pickup in U.S. inflation, it will count as a success for the Fed's extraordinary efforts to avoid the ravages of deflation that have beset Japan these past two decades.