

## Portfolio Insight

2nd Quarter 2009

Only a few months ago, the palpable fear of a market meltdown and the reprise of another Great Depression weighed heavily on investors' minds. With the Fed having thus far staved off catastrophic insolvency in the banking industry, equity markets seem to have generally settled and may have found a bottom. In our opinion, the odds of the US falling into a prolonged depression have abated. Although the financial crisis may have largely passed, the US is undoubtedly faced with difficult economic conditions. We have been living beyond our means for many years and now have the debts to show for it at both the consumer and governmental levels. The employment market is weaker now than at any time in many decades and likely to recover slowly once it bottoms.

Our federal government recognizes these problems but can do only so much to rectify them through monetary and fiscal policy. In fact, it seems perverse that the Keynesian deficit spending being used to get us out of our near-term

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problem of a weak economy may only exacerbate our most serious long-term problem; i.e., too much federal debt. Federal budget deficits are currently at an unprecedented level and both the Obama administration and the Congressional Budget Office project large deficits for years. Much of the current and future deficits result from entitlements for the largest segment of our population, the so-called Baby Boomer generation. As this group enters retirement, obligations for Social Security and Medicare will inevitably grow. The Obama administration has expressed a desire to reduce the deficits, relying on economic growth and tax increases for the means to do so. Unfortunately, their baseline economic forecasts seem unattainable. Real GDP growth of 4% for a decade has not been achieved on a sustained basis since the 1960's. The desire of the administration and Congress to expand health care coverage to uninsured Americans also seems inconsistent with efforts to control the growth in spending for health

care. If federal, state and local governments will not, or cannot, control spending within a few years, the US is headed for difficult times.

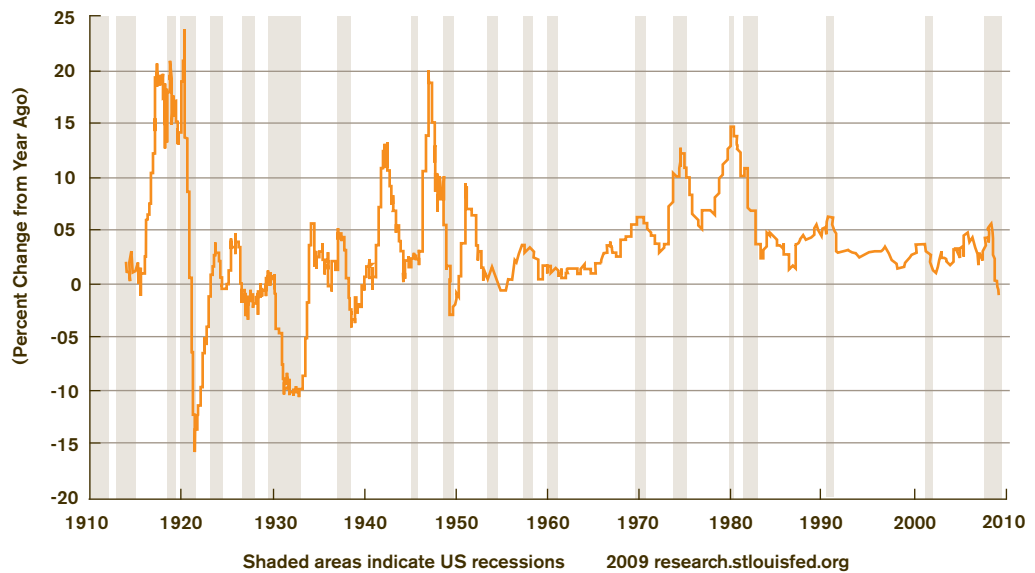
There appear to be three ways to deal with our growing debt load. The most desirable way is to control federal spending while creating a robust economy. A strong economy, alongside improved productivity, will result in higher tax revenues. The second way is to reduce government spending as a percent of GDP, especially entitlement spending, and raise tax revenues through tax hikes. The third way, and the most troublesome way for the US in the long-term, is to reduce our *real* debts through inflation. Each scenario is possible, although the first one may be the most difficult to accomplish. It is the inflation scenario that is causing much debate and concern.

### INFLATION VS. DEFLATION

The basis for inflationary fears is the Federal Reserve's greatly expanded balance sheet, which has grown over the past year in an effort to provide private sector financing and support. Over the past several months the Fed has also purchased treasury securities in order to support the government's fiscal policies. In the past, massive growth in the monetary base has usually led to inflation, the 1970's being a vivid example. Since many of today's investors lived through the 1970's experience, it is easy for them to relate to the formula: federal deficits monetized by central bank = inflation. We believe the formula may warrant additional scrutiny given current realities.

Recent actions by the Fed are merely replacing the role of commercial banks and other lenders that have been forced to shrink their balance sheets and restrict their ability to lend. This reduction in lending has caused the velocity of money in the economy to plunge. Therefore, any inflationary impact of Fed intervention in the money and capital markets is greatly reduced. **Key** to this debate is whether the Fed will be able and willing to withdraw monetary stimulus when banks start to lend again. Nobody knows when that will be. Most experts agree that the Fed has the means and the tools to withdraw the stimulus as needed. Most important of all is whether they will be pressured by Congress and/

CONSUMER PRICE INDEX FOR ALL URBAN CONSUMERS:  
ALL ITEMS (CPIAUCNS)



Source: U.S. Department of Labor: Bureau of Labor Statistics

or the Administration to keep the stimulus in place too long. The Fed has made it clear that it intends to reduce the stimulus.

Inflation doves believe that potential inflationary forces are heavily outweighed by significant deflationary forces such as a very weak housing market, consumer de-leveraging, financial system conservatism, minimal industrial pricing power due to excess capacity, and benign labor pressures due to high unemployment. The Consumer Price Index,

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the most widely used measure of inflation, in fact is now in negative territory for the first time in 50 years. Most economists now are more concerned about deflation in the near-term.

We see major differences between now and the 1970's that cause us to side for now with the inflation doves. In the 1970's the banking system was robust and willing to lend; the opposite condition exists now. Consumer balance sheets were strong and thus consumers were willing and able to borrow and spend, unlike now. Baby Boomers were becoming important factors in household formation and other consumption in the 1970's; now the opposite is true. Labor unions were much stronger in the 1970's than they are currently and had more latitude to demand

higher wages. Oil was a bigger factor in US GDP then than now and the price and supply of crude was effectively controlled by OPEC.

Inflation hawks worry that the US dollar will lose its place as the world's reserve currency. If this were to happen, the value of the dollar would decline relative to other currencies. A significant decline in the dollar could result in increased inflation in the US. However, despite public comments from China, Russia, and others declaring their desire to create an alternative to the dollar for their foreign currency reserves, these countries have two strong incentives for maintaining a strong dollar. The first is that a weaker dollar makes it more difficult for those exporters to sell to the US. The second is the fact that 65% of their foreign currency reserves are held in dollars. A decline in the value of the dollar would result in a decline in the value of those holdings. In recent years, commodities have been the recipient of some of the reserves of those countries, but as the prices of those commodities fluctuate, so does the value of their holdings. And commodities do not pay interest. We accept that the dollar is likely to decline in value over time but do not believe such a decline will be swift nor that it will immediately foster high inflation.

The traditional conditions for inflation, such as high aggregate demand and shortages of industrial capacity, labor and commodities, do not currently exist in the US. We are not ruling out future

inflation, but we believe that concerns of worrisome inflation in the immediate future are premature.

While there is much to be concerned about in the economic picture, the long-term outlook for equities is not bleak. The 1970's saw difficult challenges, too. Early in that decade the US faced major problems like the Vietnam War, violent political demonstrations, Watergate, the Arab oil embargo, a declining dollar and quickly rising inflation, which peaked at 11%. These conditions contributed to a major bear market which began in early 1973 and lasted until late 1974. Coming out of that bear market, inflation declined into late 1976 to a level of 5%. In early 1977, inflation took off again finally reaching a peak of 12% in 1980. However, during those high inflation years of 1977 thru 1980 the S&P 500 returned 11.7% per year. From that point in late 1980, the stock market experienced a 15% total correction and then launched into the longest and strongest US bull market ever starting in August 1982. Persistent deflation, rather than inflation, is probably the worst scenario for equities.

#### HOW ARE WE INVESTED?

The US economy is likely to be tepid for years, though we believe there will be areas of strength. There are opportunities for innovative companies in the energy, life sciences, materials, technology, and industrial sectors. Should inflation be an issue in the future, these companies possess the qualities that will allow them to grow and prosper. These include growth in units, pricing power due to high value-added products and services, and the ability to maintain profitability since their cost structures are not highly exposed to labor and commodity costs. We also continue to make commitments to shares of dividend paying companies whose payouts in our estimation are safe and well covered by earnings and stable balance sheets. As to bond mandates, the potential for inflation longer term dictates a short to intermediate laddered strategy for fixed income investments at this time.