

Inflation or Deflation?

With all of the recent actions implemented by the Federal Reserve, the U.S. Treasury, and other similar global institutions to fight the specter of broad-based deflation, one of the most common questions we get from clients is the impact of these actions on future levels of inflation. Since inflation has a tremendous influence on the performance of various asset classes, we felt it important to communicate to our clients our thinking on this issue. In this quarterly review, with the caveat that we are clearly in uncharted waters, we discuss our thoughts and the implications for managing our clients' portfolios.

The deflationary forces in the global economy have come about as a result of global efforts to deleverage balance sheets and the efforts of consumers in developed economies to increase their savings. These are normal responses to the current economic environment. However, the problem becomes apparent when everyone around the globe is trying to increase savings and reduce debt at the same time. The situation requires governments and central banks to act in the exact opposite fashion, spending more than the private sector is trying to save to maintain aggregate nominal demand, and becoming the buyer of last resort for the levered private sector's attempts to deleverage through the sale of assets and equity. The efforts to deleverage are probably the more difficult to combat due to the lack of political will to essentially nationalize the losses of the banking system. In fact, Ben Bernanke discussed this on his recent appearance on *60 Minutes*, when he said he believed the most severe risk we face in solving this crisis is the lack of political will.

In an effort to combat the deflationary forces that have accompanied the global economic recession, interest rates have been slashed to historically low levels, fiscal stimulus packages have been initiated in every corner of the globe, and various debt guarantee programs have been put in place to help cleanse banks of troubled assets. The most recent measure to be instituted is the process of quantitative easing recently started by the Federal Reserve and several other global central banks. Under this program, the Federal Reserve will buy \$300 billion in US Treasury bonds (primarily 2-10 year maturities) and over \$1 Trillion in mortgage securities. This effectively lets the Federal Reserve work with the Treasury to monetize long-dated Treasury securities, facilitating a huge expansion in Treasury debt at low interest rate levels. The IMF projects a sharp rise in government debt in the developed world (from 80% of current GDP currently to an estimated 104% in 2014) as governments take over private sector leverage by financing bank bailouts or by injecting cash onto consumer balance sheets.

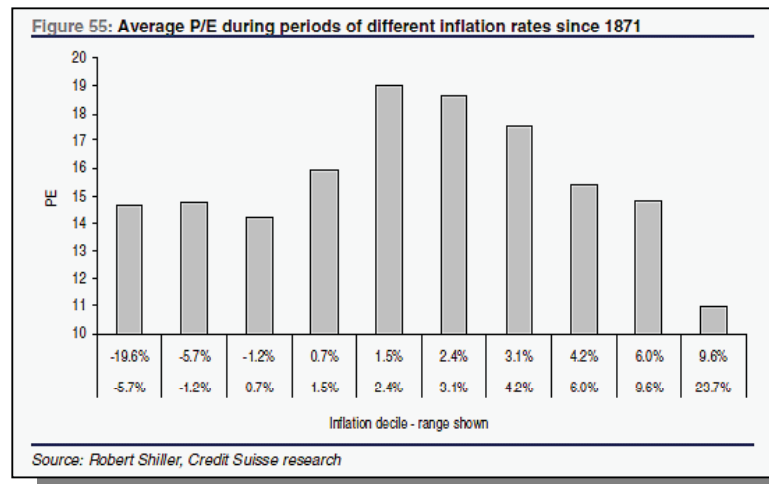
Further steps will likely be taken to combat global deflationary risks. This will mean more global quantitative easing, with the Europeans eventually joining the ranks. Countries with excess savings will unveil more fiscal stimulus plans. And ultimately, the collective political will of all involved governments will be required to execute a plan to purge the toxic assets from bank balance sheets.

In any normal time, and maybe even in these times, these operations would in the long run be inflationary. Those most worried about inflation see inflation in purely monetary terms – that it is the result of too much money chasing too few goods. The concern is that inflation will quickly result when the money supply grows at a rapid rate.

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The Federal Reserve is walking a fine line between trying to stimulate aggregate demand without creating significant inflationary pressures. As the balance sheet of the Federal Reserve approaches \$4 trillion, they are proceeding on the assumption that, once the crisis fades and the economy enters a recovery phase, they can absorb excess liquidity and avoid a significant breakout of inflation. There are a number of tools at their disposal, but history suggests the ability to time everything right is very difficult. Richmond Federal Reserve President Jeffrey Lacker, a strong anti-inflation hawk, summed up the potential quandary facing the Fed with his recent statement that the inflationary impact of the Fed's actions "depends on our skill at the Federal Reserve in withdrawing the stimulus in a timely way. This is very delicate, very hard policy."

If the Fed gets it wrong and higher global inflation emerges in the near term, how should portfolios be positioned? Looking at how various assets classes performed in previous periods of inflation in the U.S. provides cloudy conclusions. In the 1970s, gold and commodities led the way while equities and bonds were the laggards. However, the 1970s is somewhat of an outlier as, at the time of the oil shock in 1973, equities were richly valued (20X earnings) and there was a dislocation owing to the response by policy makers to inflation in the form of price controls. In the 1970s, the supply shock of higher oil prices caused the recession and inflation. With the current gap between existing economic conditions and potential non-inflationary growth so wide, unless there is an external shock, inflation is likely to be caused by an improving economy. During most previous periods of inflation (excluding the 1970s), cash and equities were the top performers, with gold and commodities trailing. In the current environment, we believe a modest increase in inflation would be positive for equities, as indicated in the chart below which shows average earnings multiples for various levels of inflation.



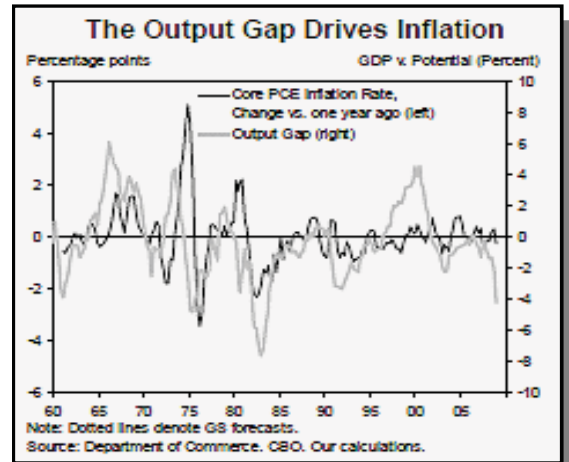
Index-linked bonds are likely to be the best vehicle in the fixed income arena, while commodities are likely to be decent performers if higher inflation is coupled with faster economic growth. Certainly, the worst outcome for most asset classes is if the Fed has to confront higher inflation before the markets stabilize and the economy has emerged from recession. In this case, the Fed will have to tolerate higher inflation for some period or tighten its policy in the face of significant economic and market weakness.

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However, we differ from the current consensus belief that now is the time to position for extremely high inflation. While the recent sharp rally in equities off the March lows - lead by inflation plays, cyclical shares that benefit from faster economic growth, and the depressed Finance sector - is based on the belief that economic conditions are slowly becoming "less bad", the recovery is likely to be modest reflecting the largest output gap in the last 75 years.

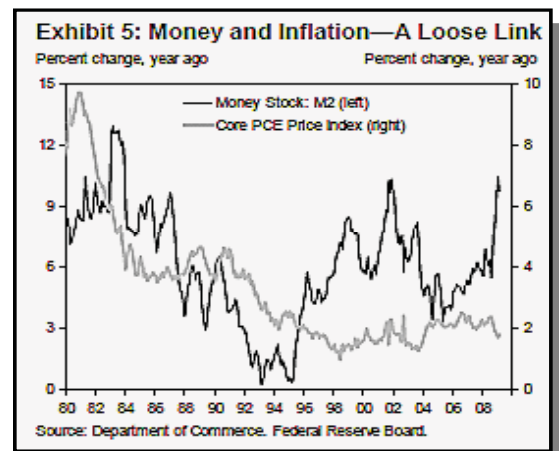
The output gap measures the difference between current economic activity and its long term non-inflationary potential. The projected gap shortfall is likely heading to nearly a 10% real GDP level by the end of next year, the largest in the post WWII period. Global spare capacity is also likely to rise to a post-war high. As seen on the chart to the right, changes in inflation are strongly correlated with the output gap.

As reflected on the chart, it took two years to close an output gap half this size coming out of the recession in 1974. It took 5 years of 5% economic growth to close the gap coming out of the 1982 recession, and during that period inflation did not accelerate significantly. While the monetary base has grown significantly, broader measures of money supply have risen much more slowly as a result of banks keeping reserves at the Fed. Therefore, the velocity of money and the money multiplier have collapsed, short-circuiting inflation for now. The correlation between the economic output gap and inflation has historically been much closer than inflation's correlation to the growth in money supply that many are concerned about today (see chart below right).



Historically, as recessions come to an end, it takes at least two years to close the output gap, with the average time closer to four years. If historical precedent holds, it is unlikely that an inflation problem will arise before 2011 at the earliest, even if the current recession were to end today.

While significant inflation does not appear to us to represent an immediate threat, modest inflationary expectations seem imbedded in recent market moves as some economic indicators suggest a slowing in downward economic momentum. Commodities have outperformed recently, more cyclical stocks have returned to favor, and breakeven rates on TIPS and GIPS (Treasury & Global Inflation-Protected Securities) have moved up. However, in the modest recovery that we expect, we believe that eventually the equity market will place a premium on companies that are able to deliver earnings growth in this challenging period of below trend economic growth - something not evident today.



In short, our answer to the question of whether the explosive growth in the monetary base implies significant inflationary pressure is: "No, not yet, but stay tuned." We believe there will be more opportune times to add more inflation protection to clients' portfolios.

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