

U.S. STRATEGY REPORT

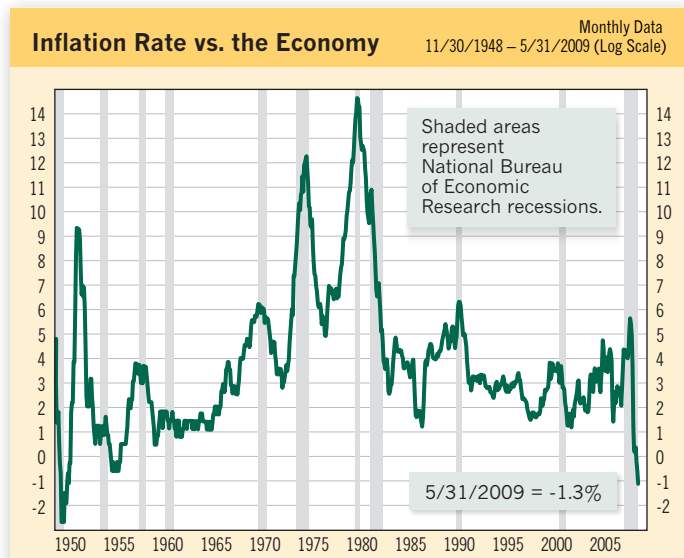
10 INFLATION PRINCIPLES

Over the past 30 years, inflation has been one of the most feared and least understood variables in the investment outlook. Much like the Great Depression shaped attitudes and behavior about money and investing for an entire generation, the inflation acceleration from the mid-1960s through the early 1980s continues to haunt investors today, in spite of the fact that inflation has fallen consistently for most of the past 27 years.

We don't dismiss inflation concerns, by any means. The steep rise in inflation had an enormous negative impact on the economy and the financial markets. Ignoring the inflation threat is naive. But a greater understanding of inflation and its causes can lead to better investment decisions. Investors who rush into "inflation hedges" at the wrong time and in an unbalanced way can wind up with huge investment losses. For example, consider the plunge in commodity prices that took place in 2008.

A Long-term Perspective

This graph shows the rise in inflation in the 1960s and 1970s, and the long-term decline in inflation since the early 1980s. It also shows the recent plunge in inflation that has occurred during the current financial crisis. The gray bars indicate times of economic recession.



Source: Ned Davis Research. Inflation is represented by the Consumer Price Index.

In order to better guide your decision making in response to the inflation threat, we offer these 10 inflation principles.

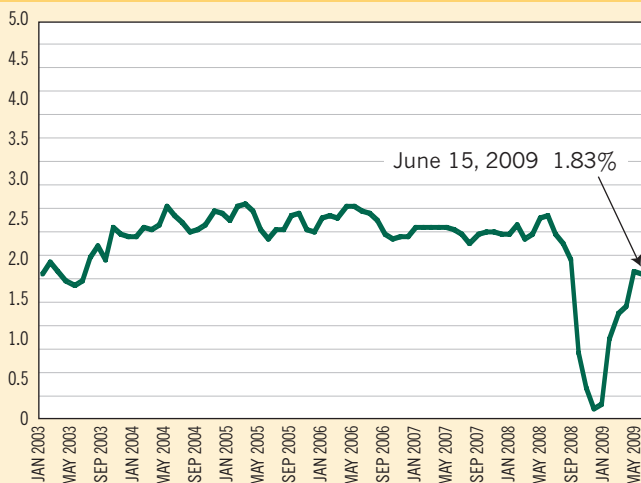
10 Perennial Inflation Principles

- 1. Inflation has been a fact of life in the U.S. economy for most of the past 200 years.** It has always been, and should always be, an important consideration when setting one's investment policy.
- 2. Stock and stock mutual funds have been a better hedge against inflation than bonds over the long term.** We recommend they be well-represented in most investors' portfolios. While stocks and stock mutual funds are riskier than bonds in the short run, they represent an ownership stake in companies that have the ability to raise prices, which has made them a more effective long-term inflation hedge. The potential for rising income that stocks offer can be an important offset to rising prices over the long term.
- 3. Focusing on quality and diversification for your stocks and bonds is better than "chasing" various inflation hedges.** Stock portfolios should be balanced between industries that may benefit from inflation, such as energy and mining, and other sectors. Mutual funds can help accomplish this. Bonds should be laddered by maturity (short, intermediate and long term) because bonds with a longer maturity can fall more if inflation and interest rates rise.
- 4. Certain inflation hedges, such as commodities and real estate funds, can improve diversification, but they are extremely volatile and should be owned only in modest amounts.** We recommend clients invest in these "niche" asset classes through an advisory program or an asset allocation fund where an investment professional can maintain an appropriate weighting in these investments based on investor risk tolerance and other factors.

5. A steady, predictable rate of inflation of around 2% to 3% is a characteristic of a healthy economy. An accelerating inflation rate (above that level) could have a negative impact on stock and bond prices. Inflation expectations change constantly but have recently risen to a little below the average of 2% over the next 10 years.

Long-term Inflation Expectations Are Tame

Difference between 10-yr Treasury Yields and 10-yr TIPS



Source: Federal Reserve. Treasury Inflation Protected Securities (TIPS): The Internal Revenue Service considers the inflation adjustment in any given calendar year to be federally taxable (though it is not subject to state and local taxes). Investors must report the adjustment and pay tax on it even though they will not actually receive any principal until maturity. Past performance does not ensure future results.

6. Disinflation (a falling rate of inflation) has been a characteristic of our economy since 1981. That falling rate of inflation was a major contributor to unusually high returns on stocks and bonds, a condition that is unlikely to be repeated in the near future.

7. In terms of economic recovery, price stability is key.

While the U.S. Federal Reserve (Fed) has recently engaged in actions designed to rescue the economy from a major meltdown, its actions over the long term suggest a major commitment to maintain price stability. A number of other countries – notably those that adopted the euro as a common currency – have also accepted price stability as the primary goal for their monetary policies.

8. In addition to the efforts on the part of the world's central bankers, three other factors have helped keep a lid on inflation.

- Labor costs, which account for roughly two-thirds of the cost of doing business in the U.S., have been tame. For comparison, commodities account for less than 10% of the cost of doing business.
- Technological innovation has raised productivity.
- Intense global competition has helped to keep a lid on price increases.

9. Deficits alone are not a cause of inflation. Monetizing the debt (which is when the Fed prints money to buy government bonds) can be inflationary if it's excessive. The Fed has recently monetized some debt in light of the current financial crisis but also has stated its commitment to avoid further monetization.

10. Most investors should consider creating an income stream that maintains a desired standard of living after taking inflation into account. Accomplishing this goal, in our view, requires a balanced approach to investing that addresses not just the risk of accelerating inflation, but other risks as well. For example, maintaining a large commitment to short-term income investments presents the risk that an investor's purchasing power will fail to keep pace with inflation over the long run.

Government's Response to the Financial Crisis: Is It Inflationary?

The aggressive response from policymakers was in part designed to prevent a dangerous deflationary spiral that would lead to a climate of falling prices. Such a condition is very difficult to pull out of, as Japan discovered in the 1990s.

It's only natural that the extraordinary actions taken by the federal government to avoid an economic calamity would cause some investors to consider the potential long-term consequences – one of which might be higher inflation. Remember, though, that policymakers – primarily those at the Fed – share these concerns and have expressed a strong desire to avoid rekindling the inflation fires. Reversing stimulus as the economy recovers is a delicate balancing act, but achieving this balance is always the job at the Fed.

What about the Deficit?

The enormous budget deficits, both accumulated and anticipated, present a different set of challenges. Once the economy is on a stronger footing, it will be essential for Congress and the president to address our fiscal imbalances in a credible way. It will be tempting to "inflate" our way out of debt, but the market will watch policymakers closely.

One of our favorite sayings on this topic is, "Politicians propose, but markets dispose." In other words, if inflationary policies are pursued, the markets will likely signal their displeasure quickly and clearly. This "discipline of the markets" is a lesson that federal lawmakers learned the hard way in the late 1970s and early 1980s through rising interest rates. We haven't reached the point where accelerating inflation is a serious long-term threat to our economy, but we'll continue to sleep with one eye open.