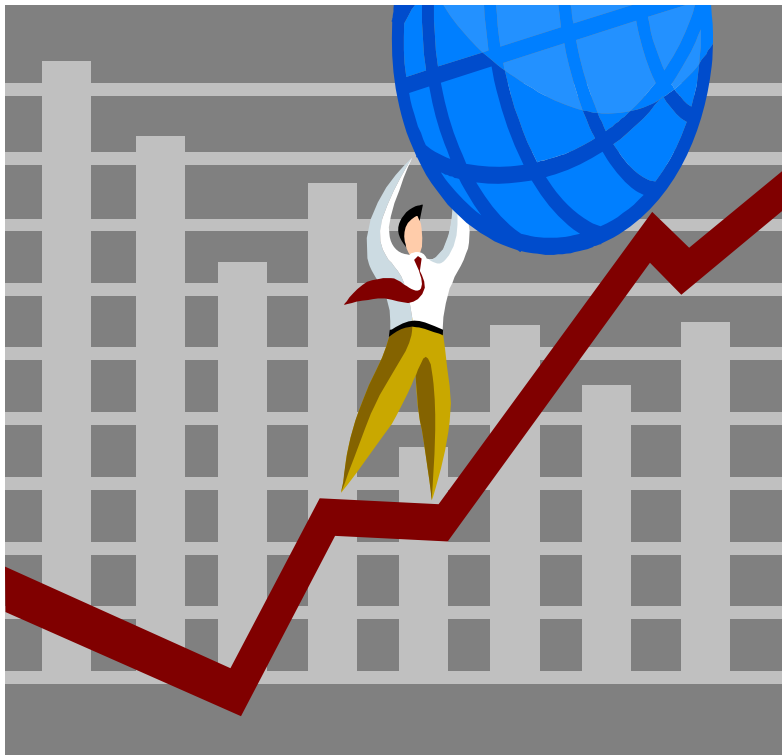


Inflation on the Rebound?

2010 Q1 Quarterly Commentary



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Inflation on the Rebound?

Much has been written recently on the likelihood of inflation creeping back into the real economy. The subject needs this kind of attention because it is a complicated issue with huge implications for investors. So I want to share Weyland Capital Management's ideas with you on what inflation means to investors in the short-term as well as offer something to consider about inflation in the intermediate term.

At first blush, the idea of inflation reemerging seems to be a no-brainer given the amount of stimulus that governments and central banks have injected into the global economy. Then, when you add economic reports that have been running quite strong recently as well as factor in proven forecasting models like the Economic Cycle Research Institute's U.S. Future Inflation Gauge (USFIG) which are now at 18-month highs, you can see why there is real concern.

On top of that, there is growing evidence of increasing inflation pressures in the commodity and bond markets. Prices of oil and gold are going up and interest rates are climbing. While rising commodity prices lead to inflationary pressures, the biggest factor that drives inflation is wage growth since it represents a much larger slice of production costs than commodities.

However, there is less inflationary pressure on that front. Unemployment peaked this cycle at its highest level in over a quarter century. High unemployment means there will be more than enough workers for new jobs, and that tends to keep the lid on wage increases. So we at Weyland Capital Management believe that inflation will be contained over the coming year.

But how about over the entire business cycle - say the next five or six years? We think it is likely that inflation will return sometime during this period, and for a reason just emerging from the ivory tower of economists that has received virtually no coverage in the business press.

Two months ago, Olivier Blanchard, Chief Economist of the International Monetary Fund, wrote a heretic note entitled "Rethinking Macroeconomic Policy." He simply asked the question: should central banks raise their inflation targets from the current 2% level to 4%.

It was almost like Blanchard had thrown a bomb. For nearly a quarter century, central banks' tactics, not to mention the conventional wisdom in economics, have been geared to reduce inflation.

The problem, Blanchard wrote, was that having achieved the 2% target level, central banks had painfully little wiggle room to lower interest rates aggressively should another major economic shock occur. Lowering interest rates, of course, stimulates spending and investment which in turn stimulates the real economy and the creation of new jobs.

Since the Fed Funds rate, the key policy lever used by the Fed to influence interest rates, typically runs close to the inflation level, and since interest rates can't go below zero, a 2% inflation rate gives the Fed only 2% of wiggle room to stimulate the economy.

Blanchard thinks that if a target rate of 4% can be achieved, it would strengthen the hands of the central banks to stimulate demand by allowing short-term lending rates to be set a full 4% below inflation. And that is very stimulative, indeed.

Another facet of higher inflation is that it reduces the real value of debt over time for any debt not indexed to inflation. And most debt is not indexed to inflation. This reduction would not be a bad thing since it would improve our biggest problem: that the debt to Gross Domestic Product ratio is too high. If GDP grows more quickly because of higher inflation embedded within it, then the payments necessary to service that debt would end up being smaller on a percentage basis.

Unfortunately, there is no free lunch here for investors since the holders of fixed-rate bonds will be paid back with inflated dollars holding less buying power. Getting the correct bond exposure is critical in such an environment.

The possibility that Mr. Blanchard's recommendation could have the side effect of depreciating the real value of public debt created such a firestorm of controversy that 10 days ago Dominique Strauss-Kahn, the head of the International Monetary Fund who is Olivier Blanchard's boss, was forced to comment: "We remain an institution that believes that low and stable inflation delivers positive benefits for growth and macroeconomic stability... And I know that Olivier was not calling for higher inflation to reduce the real value of public debt."

But the fact remains that a higher inflation rate will reduce the real value of public and private debt. And Olivier Blanchard has created the first instance of "institutional cover" for a higher inflation rate. Stay tuned.

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Client portfolio stock and commodity allocations are currently at what we call their "policy levels" - meaning that we're neither aggressive nor defensive. In bonds we have reduced risk by raising our cash levels a bit. As you may recall from our 2010 Outlook and Strategy, we predicted rates would move up this year which would make the price of bonds go down. This has recently occurred. We remain hopeful that we will be able to deploy our cash position into bonds (and possibly other asset classes) at more attractive prices.

Finally, I have one brief observation regarding the late-breaking S.E.C. suit against Goldman Sachs. If the stock market is not seriously challenged by this suit over the coming fortnight, then it can be assumed that the stock market's health is quite robust and increases the odds that stocks will move higher over the summer.

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