MACROECONOMIC QUICK TAKES

RECOVERY

The final tally for first quarter 2009 GDP in the U.S. showed an annualized decline of 5.5%. This figure represents a slight improvement over the 5.7% decline that had been anticipated and a substantial improvement over the 6.3% decline that was sustained in the fourth quarter of 2008. Moodys, a major bond-rating agency, thinks the annualized decline in U.S. GDP may fall in the range of 2% to 3% during the just ended quarter. In May, orders for durable goods increased 1.8% versus the median forecasted *decline* of .9% that had been expected by a group of economists polled by Bloomberg News while orders for non-defense capital goods (excludes aircraft) increased a stunning 4.8%. Moreover, the Conference Board's index of leading economic indicators rose 1.1% in April followed by a better-than-expected 1.2% advance in May.

Taken together, it becomes easier to understand why many analysts think the U.S. economy may begin to expand again during the ensuing quarter. Nonetheless, after its June meeting the Federal Reserve confirmed that although the pace of economic contraction is slowing in the U.S., it expects economic weakness to persist. As such, it continues its efforts to reinvigorate the U.S. economy without igniting inflation.

Internationally, the Organization for Economic Cooperation and Development said the economic downturn is near a bottom in its 30 member countries and now expects 2010 to result in economic expansion of .7% rather than the .1% contraction it had previously envisioned. This is noteworthy because it marks the first time since 2007 that this organization has revised its outlook to be more optimistic.

INFLATION CUSHIONS

The Federal Reserve has introduced massive amounts of stimulation into the U.S. economy and equity values have rebounded dramatically since early March. Recently, however, investors have become more watchful for signs of renewed inflation. After all, basic economic theory suggests that as more money chases the same amount of goods and services, the

market-clearing prices for those goods and services should rise. Consequently, the amount of chatter regarding the virtues of gold, precious metals, commodities, and other perceived inflation hedges has been on the rise. The yield differential between traditional Treasury securities and the newer versions that are structured to be "inflation protected" has widened markedly since winter which seems to suggest that price inflation is lurking around the corner.

Economists, however, see the link between an expanded money supply and the re-ignition of inflation as being somewhat less direct. In fact, many feel that run-away inflation is not a foregone conclusion. In May, producer prices for finished goods (which are a component of retail prices) rose a modest .2% while consumer prices rose only half that much. Year over year, the growth in producer prices reveals the steepest deceleration in some six decades.

INFLATION CUSHION #1 — THE "VELOCITY" OF MONEY

All else being equal, an increase in the money supply may trigger an increase in inflation to the extent the money supply grows faster than productive output. If the quantity of goods and services produced stagnates or falls (as is the case during recessions) while the money supply expands (which the Fed does to thwart recessions), prices will tend to rise, unless the *velocity* of money also falls. An equation for economic output is: **M x V = P x Q**, or:

[MONEY SUPPLY x VELOCITY OF MONEY = PRICE OF GOODS & SERVICES x QUANTITY OF GOODS & SERVICES]

Related to the notion of a money multiplier, the *velocity* of money is a concept the talking media heads sometimes forget about. In short, as the Fed introduces an incremental dollar into our economy in an effort to stimulate it, it's impact on the actual money supply is generally *multiplied* due to the fact that this incremental dollar can be spent, deposited, lent, re-spent, and re-deposited numerous times over a given time frame.

Currently, however, the velocity of this spending and lending process has slowed greatly as a result of the banking systems' reduced ability to lend and consumers' reduced willingness to spend. To rely on a metaphor for a moment, the Fed has thrown a lot of fuel into the economic furnace that is the U.S. economy knowing that some of it will eventually catch fire. To the extent more fuel ignites than the Fed considers safe, it will have to react quickly. If it

reacts too slow or gently, the result could be the equivalent of an economic grease fire. On the other hand, if the Fed reacts too harshly we could suffer a "double-dip" recession. The stakes are high and the Fed knows it.

INFLATION CUSHION #2: ENERGY PRICES

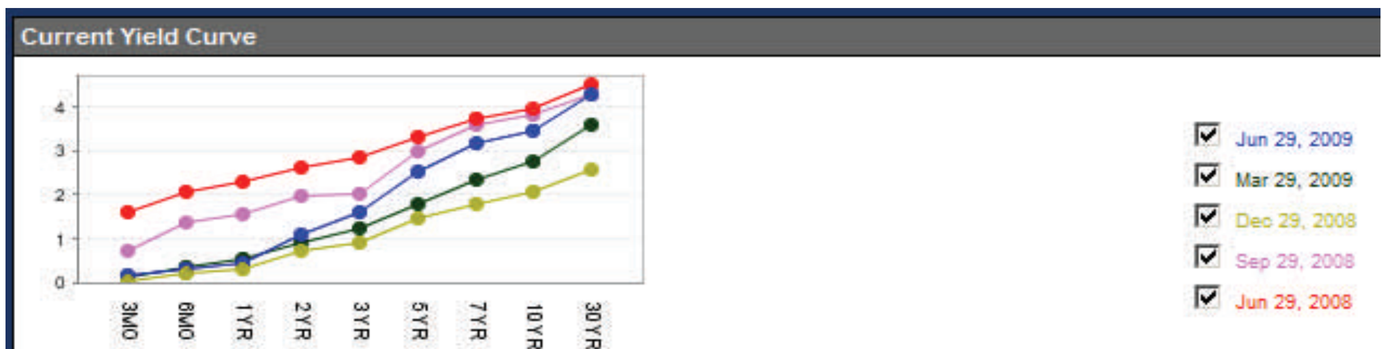
Whether used as a raw commodity or as the means by which goods are transported and services are delivered, high energy prices tend to restrict consumption and raise prices. Low energy prices do the opposite. Although many would say that oil is certainly not cheap, a barrel of oil now costs around half as much as it did a year ago. Natural gas costs only about a third as much with prices now approximating 2002 levels. Since natural gas is a major source of energy, its depressed price is thought to have a material quelling effect upon inflation.

INFLATION CUSHION #3 — UNEMPLOYMENT

Since unemployment is now generally expected to peak somewhere around 10% sometime this year or next year (graph below), economists expect this elevated unemployment rate to provide a further buffer against an impending spike in inflation. In essence, high and rising unemployment ensures that an adequate supply of labor will be available to help thwart any wage inflation that might occur in a tighter labor market.

RISING TREASURY YIELDS — MAY NOT INDICATE INFLATION

Compared to about six months ago when the Fed was scrambling, intermediate and long-term Treasury yields have risen considerably (graph on page 4). Like roosters and sunrises, however, the notion that the massive Fed stimulus necessarily *causes*



hyperinflation could be a bad read. Although the recent steepening of the yield curve (blue line, above) may suggest that inflation is imminent, a group of economists that comprise the Securities Industry and Financial Markets Association 21-member Economic Advisory Round-table are actually expecting further *declines* in inflation.

As investors panicked last winter and flocked to the safety of Treasury securities, Treasury prices soared forcing their yields to plunge. In turn, riskier debt instruments moved in an opposite fashion. Although rising yields on Treasury securities may, in fact, portend a forthcoming spike in the rate of inflation, many economists view the recent steepening of the yield curve as a natural relaxation of the previous flight to quality rather than as a precursor to inflation.

STILL HEDGED AGAINST INFLATION

Despite the logic of the foregoing analysis, we fully recognize that a) the Fed may not recognize and/or react to the onset of inflation as quickly as it should, b) conditions may change, and/or c) our analysis is simply wrong.

To the extent your portfolio includes equities, real estate, or other assets whose values are not tied *directly* to the value of the dollar, you are already at least somewhat hedged against a spike in inflation whether it occurs or not.

Let us know if you need anything.

— Glenn Wessel