WOODSTOCK

QUARTERLY NEWSLETTER

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Inflation Fears

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Many fear we are entering a period of generally higher inflation. Commodity prices, including corn, wheat, and cotton, have risen over 80% in the last year. Unleaded gasoline has increased 37% year-over-year. Government statistics do not seem to capture the extent of rising prices. The Consumer Price Index (CPI), as published by the Bureau of Labor Statistics, was up 2.7% year-on-year in March while the core inflation rate (the CPI excluding food and energy) was up 1.2% year-on-year in March. The Federal Reserve tends to place greater emphasis on the core rate when monitoring inflation because it smooths out the greater volatility of food and energy prices. If the inflationary forces evident in food and energy persist, they will manifest themselves in the core CPI over time.

The Federal Reserve has kept short-term interest rates at historical lows, and is even printing money, which seems to be causing the problem. Pricing pressures are still working their way through industrial supply chains and may continue to exert upward pressure on the CPI. The Producer Price Index (PPI), up 5.8% year-on-year, may be leading both CPI statistics. However, Federal Reserve officials, who have been focused on improving job growth, may be preparing to address emerging inflation as early as April 27th, when Fed Chairman Ben Bernanke will hold the first of four press conferences this year. The press conferences are intended to give the public greater insight into the Fed's thinking.

Indeed, the Fed has been active throughout the financial crisis, highlighted by QE1, the Fed's first round of quantitative easing. QE1 is considered a success because it helped to reliquify the banks and helped the public overcome fears of deflation. In many ways, QE2 has also been successful. In the second half of 2010, the Federal Reserve decided that the US economy was growing too slowly, and that further monetary easing, in the form of QE2, would offset the still extant deflationary forces of declining home values and high unemployment.

Chairman Bernanke first announced his consideration of QE2 in a speech in Jackson Hole, Wyoming on August 27th. Since then, the S&P 500 Index has rallied more than 20%. The U.S. economy has clearly turned the corner too. Real GDP grew 3.1% in the fourth quarter of 2010, following 2.6% growth in the third quarter and 1.7% in the second. The Institute for Supply Management's index of manufacturing conditions was 61.2 in March, and has averaged 59.5 over the past six months. Any reading over 50 indicates economic expansion. Employment gains have lagged even more than they typically do recovering from a recession, but finally seem to be picking up.

While the stock market has reacted favorably to QE2, there have been some criticisms and less favorable implications of the policy. Although statistical scorekeepers in Washington would have observers believe that inflation remains subdued, consumers have been squeezed by elevated prices. Wages have not kept up. Furthermore, employment has not improved as rapidly as many would like. These tensions have created a lot of anxiety, particularly among lower income consumers and people on fixed incomes. The policy seems to be expanding the gap between the less fortunate and high income earners.

While the CPI may continue rising, commodities are likely to indicate a directional shift in inflationary pressures. Commodity prices tend to lead CPI levels, although they are more volatile. Listed below are several factors which should moderate pricing pressures going forward. First, QE2, at $600 bn, was only a fraction of the size of QE1, at $1.7 trillion, so by size alone the inflationary forces should be reduced. Meaningful inflation did not materialize after QE1 was announced two years ago, at least in terms of the Federal statistics. One could argue that banks still have large excess reserves, suggesting that QE1

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could still have an inflationary impact on the economy. The Fed may have to aggressively tighten monetary policy to drain excess reserves before they become inflationary.

Second, even if QE2 is responsible for kindling inflation, it's about to expire: the Federal Reserve's program to buy an additional $600 billion Treasury debt will end in June. QE2 has been absorbing about $75 billion of Treasury debt per month, effectively monetizing the fiscal deficit. The Congressional Budget Office (CBO) has forecast the Federal deficit to be $1.4 trillion this year, or approximately $117 billion per month before adjusting for seasonality. When QE2 ends, the withdrawal of the Fed as a large buyer is likely to weigh on the supply/demand balance for Treasury debt, driving interest rates higher. We are heading for a more constrained monetary environment by default, unless the Fed changes course.

Will there be a QE3? Right now the political climate in the US would not lend itself to a third quantitative easing program. The general level of anxiety ~ or misery ~ has provoked a political backlash against the Fed. A number of Congressional leaders have expressed dissatisfaction with Federal Reserve policy. If deflationary forces set in again, we cannot rule out QE3, but the economy and inflationary forces would have to weaken considerably before such a program would be politically possible.

The misery index, which is comprised of the unemployment rate plus the inflation rate, is rising (see chart below). Arguably both sets of government statistics understate the current level of misery. The lesson of the 1970s, and perhaps of QE2, is that expansive monetary policy cannot improve economic prospects over the long term – inflationary concerns simply add to the economic problems. The consequence of extended monetary easing would be stagflation.

Third, there are other drivers of commodity price inflation. Emerging markets have seen their own rapid growth, creating significant external demand for commodities. With four interest rate increases and seven reserve requirement hikes in China, China's economic growth is set to moderate from its torrid pace. Also, over the last 12 months, the world has been prone to numerous supply shocks. Extreme droughts in Russia last summer destroyed up to 14% of that nation's crop production. Similarly, floods in Pakistan covered up to 20% of the country's land mass, displaced 20 million people, and destroyed $3 billion worth of crops. In January, flooding in Queensland, Australia destroyed crops and disrupted mines responsible for almost half the world's supply of metallurgical coal. If weather normalizes in 2011, we are likely to see commodity prices recede.

Fourth, in so far as the Federal Reserve's newly printed money found its way into speculators' margin accounts, surely at some point these speculative trades in commodities will reverse, as they did in 2008. Rising interest rates and a strengthening US Dollar would be most instrumental in bringing about a retreat from the commodity trade.

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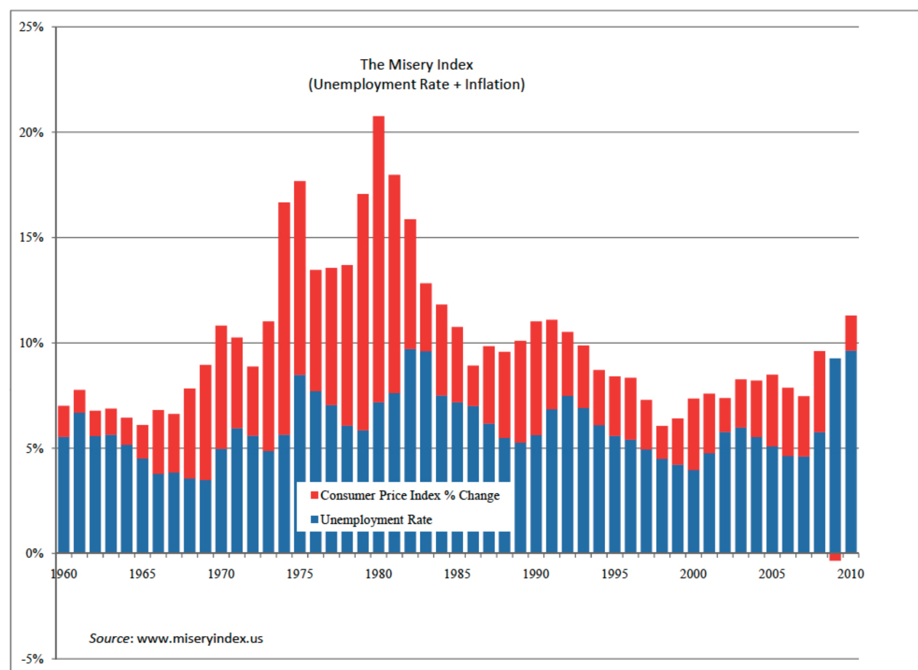

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Oil is up because the global economy is recovering, but there is also a premium factored into oil because of instability in the Middle East. In particular, the civil war in Libya has removed 1.4 million barrels from daily production. While not good news for prices, the Libyan supply shock probably does not represent a permanent change in the general price level. The devastating earthquake and tsunami in Japan are proving to be both a demand and a supply shock. Our deepest sympathies and prayers go out to the Japanese people, and to the Libyans fighting for their freedom. In the intermediate term, 1-3 years, Japanese reconstruction is likely to require much greater importation of diesel, natural gas, and construction materials, keeping prices at elevated levels.

We are confident that the Federal Reserve will take whatever actions are necessary to assure that pricing pressures remain contained. Just as increases in the CPI tend to lag commodity price increases, the diminution of inflationary pressures may take awhile to reduce CPI growth. As higher prices work their way through the economy, pricing power and low cost of capital are likely to be important determinants of stock performance. We therefore believe investors will be able to navigate the investment landscape safely with high quality stocks. Some investors may appreciate the use of Treasury Inflation-Protected Securities (TIPS) as an appropriate way to hedge the fixed income portion of their portfolios against inflation.

The longer term threat of inflation in the U.S. arises from our ever rising debt burden. Federal expenditures are expected to be $3.6 trillion or 24.1% of GDP this year, while tax revenues are expected to be $2.2 trillion or 14.8% of GDP. The resulting deficit, 9.3% of GDP, is not sustainable. The CBO projects that under current budgetary forecasts, our national debt will rise 3x to 146% of GDP over the next two decades (see chart below). Probably well before this point, bond investors will start to question the country's willingness to pay off its debts. Investors will demand higher interest rates for assuming greater risk of default or devaluation. When debts achieve high levels relative to GDP, countries must choose among three unpleasant options: long periods of austerity, debt default, or inflation. Historically, most governments with paper currencies have opted for inflation.

However, the U.S still has time to prevent run-away inflation. It should be a policy imperative to get spending under control. There have been some motions in Congress along these lines, and we hope they gather steam in time for the 2012 elections. Cutting the deficit may itself be near-term deflationary, but in the current environment of rising prices, maybe that's not such a bad thing. ◆

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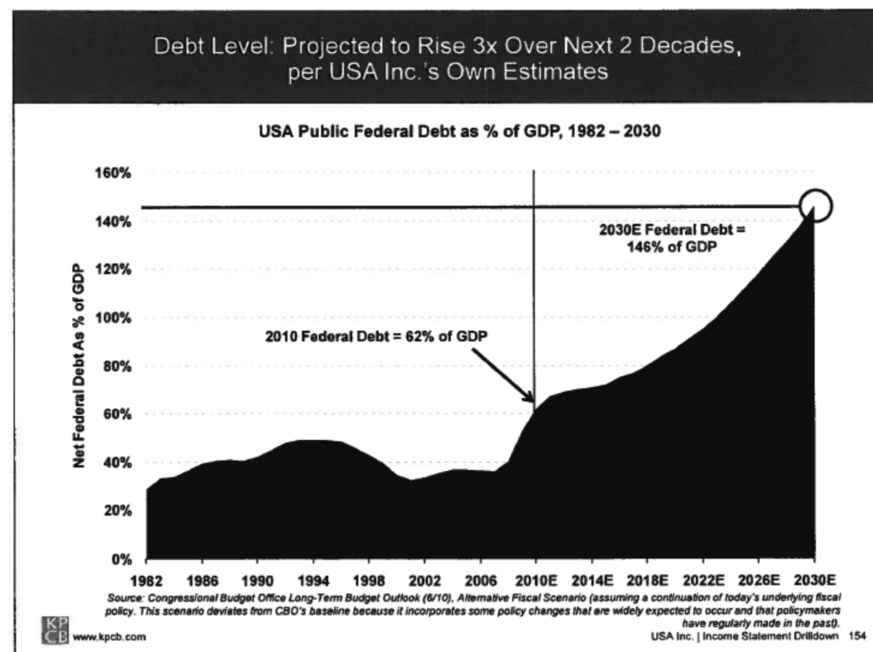

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