

# Investment Update



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WEALTH MANAGEMENT

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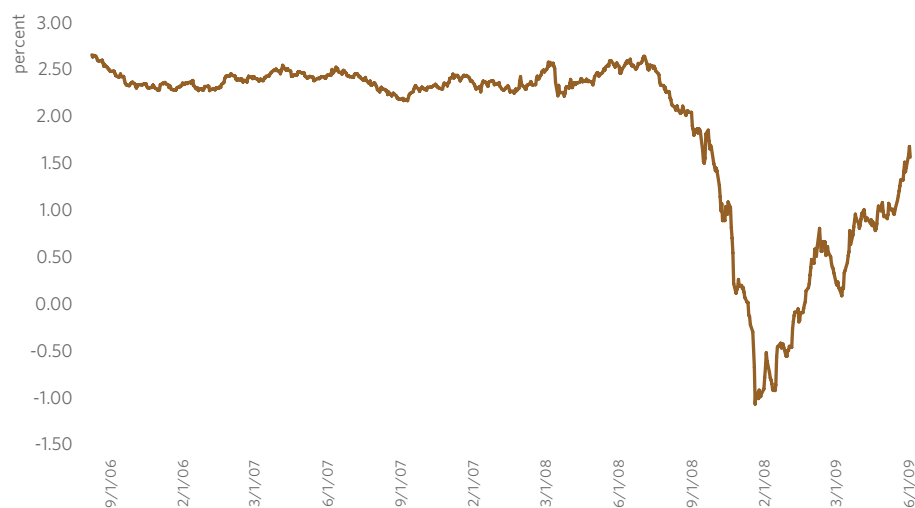
## The Distance Between Here and There

When markets move in line with the view you have expressed, it can be gratifying. However, when such a shift happens rapidly, as has recently been the case, we should step back and examine the possibility that investors may have overreacted.

In the grip of the extreme fear that existed late last year, investors understandably placed a high value on safety. We felt, however, that investors were not adequately considering the possible future inflationary implications of policy enacted to quell the economic and financial market collapse. At the time, 10-year maturity Treasury yields were near 2%, and the embedded inflation expectation in TIPS (Treasury Inflation Protected Securities) was near zero. We did not believe that these levels resulted from a reasoned assessment of the probability that inflation would truly be zero over the next 10 years, but rather from the perceived need for safety at any cost. Once conditions began to stabilize, or even to decline at a less precipitous rate, we felt that investors might begin to recognize the potential future costs of recent stimulus measures. As illustrated in the chart below, this indeed has been the case.

## Inflation Expectations Have Risen

TIPS Yields Compared to Nominal Treasury Bond Yields (10-Year Treasuries Issued Mid-2006\*)



\*Treasury 4.875% 08/15/16 Versus TIPS 2.50% 07/15/16; June 3 1.56%

Source: Bloomberg LP

Although we expected this progression, we have been surprised by the degree and speed with which those asset classes that may benefit from inflationary pressures have been repriced. Rising commodity prices, especially oil — which almost doubled from the lows earlier this year, and equity prices, notably those of emerging market equities, reflect improved investor confidence in economic recovery and fear of future inflation.

Meanwhile, Treasury yields also almost doubled from their crisis lows, prior to falling back somewhat more recently.

Although many investors now appear to anticipate future inflation, the challenge may be in correctly estimating the time it takes for this likelihood to be manifested. Given recent prodigious increases in many investments that may provide inflation protection, we are concerned that investors have unrealistically shortened the distance between “here” and “there.” There, i.e., the future, may include possible inflation. However, here, otherwise known as now, the economy remains strained, and we expect a relatively subpar recovery.

The May Durable Goods Report, released June 24th, provides an example of the type of improved economic data that the market has been receiving. Orders for durable goods unexpectedly rose by 1.8%, further signaling companies’ confidence that the recession is waning. This report fits an ongoing pattern of transition from “less bad” to “good.” While hardly an indication of a vigorous recovery, continued reports such as this could be signs that the U.S. economy is moving beyond less bad into a better — although still not good — state.

Considering slackened labor markets and industrial capacity, we do not expect inflationary pressures to build overnight. The manufacturing capacity utilization rate dropped to a record low of 65% in May, and unemployment almost certainly

is headed above 10%. We believe that current conditions will require several years to dissipate, especially with the anticipated headwinds of consumers continuing to build savings and at least attempting to reduce debt.

Given our view that inflation risk was not being properly priced by investors, we recommended allocation changes, where appropriate, to several asset classes that we felt could offer some protection from future inflation. Recent changes in investor sentiment and the accompanying positive market action have diminished this opportunity, at least over the near term. While we remain concerned about inflation in the longer term, those making pronounced shifts toward investments that offer perceived inflation protection may be disappointed in their hope that performance will mirror recent market successes. While we likely will add to investments such as these in the future, we will attempt to do so at advantageous price levels.

The language from the May Federal Reserve meeting minutes, released June 24th, reflects our misgivings about investors' timing misperceptions as they relate to inflation acceleration. The Fed commented that, "...substantial resource slack is likely to dampen cost pressures and the Committee expects that inflation will remain subdued for some time." The minutes also called into question the growing belief that the Fed might raise short-term rates in the near future. We have not felt that a rate hike was likely and for the present, the Committee appears to agree.

Some claim that the rapid rise in asset prices is irrational, but we would argue otherwise. As an extreme market collapse and prolonged economic contraction became less likely, it was appropriate for investors to reprice risk. Inflection points often coincide with high volatility and uncertainty. The resulting rapid shifts in sentiment and price movement, such as we have witnessed recently, are one reason we advocate taking a long-term view, while remaining flexible enough to capitalize on short-term opportunities.

Despite extremely challenging overall conditions, we have been able to identify and capitalize on several of these short-term opportunities. By waiting too long, such opportunities more often become, at best, a more even risk/reward bet. We prefer to attempt to step in when the odds are more favorable. Those who wait for prices to adjust to confirm their beliefs often miss some or all of the opportunity. As Warren Buffet has said, "You pay a high price for consensus in the stock market." At the same time, we do not want to place portfolios at significant risk of failing to achieve their long-term goals. For this reason, we do not advocate extreme shifts in asset allocation based on short-term market dynamics.

### **The Pause That Refreshes**

The stock market has undergone what so far appears to be a modest correction. The March through May increase was extreme and occurred over a very short timeframe, with fairly light trading volume toward the end of the period. For this reason, last month we suggested that the markets might experience a price correction rather than a time correction. In other words, markets might mark time and wait for underlying fundamentals to catch up. Because underlying economic conditions continue to improve, albeit gradually, we view the recent decline as a consolidation rather than a reversal. If equity markets do decline much further, we may view this as a more favorable opportunity to add to positions rather than sell. This decision needs to be applied to each portfolio as appropriate and may not be suitable for all portfolios.

We do not expect markets to retrace all the gains that have been made. Compared to the highly uncertain conditions investors faced in late February, the situation has improved markedly. However, it remains our view that investors will need to see more convincing signs that the economic improvement is accelerating before they are willing to bid equity markets significantly higher.



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