

A WHIFF OF INFLATION?

Probably the hottest area of debate in financial circles currently is the subject of inflation. It's interesting that inflation is now so topical, since it was only a few months ago that the consensus view centered on the prospect of *deflation*. Since then, modest signs of economic revival have begun to appear, and the prices of both financial assets and commodities have firmed. The slowing rate of decline in economic activity has caused most observers to conclude that the crisis scenario is off the table and in its place now is the prospect of recovery and what it may mean for inflation. No issue is more critical to securities prices than the level and direction of interest rates, which are largely a product of inflation, so it's worth thinking about what the future holds in this respect.

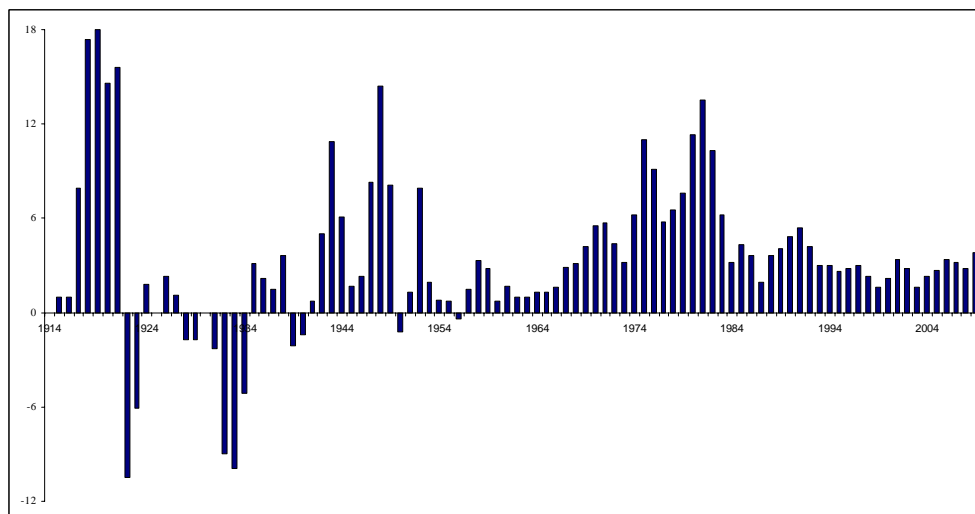
One of the simplest and most useful definitions of inflation comes from the Michigan State Senate (perhaps ironically, since Detroit has experienced its opposite lately): *a rise in the general price level that results in a decline in the purchasing power of money*. As consumers, we worry about inflation because it reduces our purchasing power. As investors, we are penalized when inflation pushes up interest rates and reduces the value of securities. Either way, excessive inflation is a serious problem.

Some historical perspective may be helpful in assessing today's situation. The chart on the next page shows almost one hundred years of inflation data, as measured by the Consumer Price Index. The most notable spikes in inflation came during World War I and World War II, and in the decade through 1982. On the other hand, the only period of extended deflation occurred during the Great Depression. These periods remind us that there are two general types of inflation—"demand-pull" and "cost-push." During the two world wars, total demand for goods and services was heavily stimulated by the need to conduct warfare on a major scale while the rest of the economy continued apace. The huge incremental demand eventually caused prices to rise. The Great Depression represents the other side of demand-pull. The Crash of 1929, followed by protectionist trade restrictions, caused such a sudden decline in economic activity (i.e., demand) that prices had nowhere to go but down.

The 1970s inflation episode had its origin in the Vietnam War but then was intensified by steep rises in commodities costs—most notably oil. In October, 1973, in retaliation for the United States' support of Israel in the Yom Kippur War, OPEC raised the price of crude by 70% to \$5.11 per barrel, imposed an embargo, and agreed to production cuts, leading to an increase to \$12 a barrel within a year. The ripple effect on consumer prices took almost a decade to finally contain, beginning with an attempt at price controls (remember "WIN" buttons—Whip Inflation Now?) and ending with constrictive monetary policy that finally turned the tide.

As things stand currently, there is very little evidence of inflationary pressure in the economy. Despite the rise in certain commodity costs, demand is so slack that overall price levels are stable. Rather, it's the two- to five-year outlook that worries a growing number of investors. To the extent that the capital markets are discounting mechanisms, they are beginning to send signals that inflation could become a concern as the recovery unfolds. Let's look at some of the signs.

Consumer Price Index (1914 – 2008)



Source: Standard & Poor's, Bureau of Labor Statistics

Economic Slack

As we've said, the economy's continued weakness argues for a benign inflation outlook for the foreseeable future.

- ***Capacity utilization:*** The depth of the recession and the angle of decline in economic activity, at least up to this point, suggest that it will take several years for inflationary pressures to build. U.S. manufacturing production is now a full 16% below its peak in December, 2007, and capacity utilization has dropped ten points, to 69%, in the last twelve months. In fact, capacity utilization is 11 points below its *average* of the last 25 years. The auto industry is a great example: worldwide production capacity is 86 million vehicles a year, but only 56 million are likely to be sold this year, according to the *Financial Times*. Typically, it takes capacity utilization's pushing the upper limits of its range, thereby creating a psychology of shortage, to trigger a major resurgence of inflation. If manufacturing were to resume growth at, say, 4% (probably an optimistic assumption), it would take three to four years to get back to normal utilization rates—and that assumes no additions to capacity in the meantime.
- ***Deleveraging:*** If the U.S. has learned anything from the experience of the last 18 months, it is that we should operate with less leverage as a nation. Certainly, financial institutions have gotten religion (although forced) in this respect, as they have lowered their debt loads through a combination of selling assets and raising capital. In a somewhat amazing display of resilience, the banking industry has sold over \$70 billion of equity since shortly before the stress tests were imposed. Throughout the decade, most large corporations have restructured their balance sheets to the point where they are generally in good shape, but the recession has caused many to hoard cash even more. Finally, the consumer is just beginning to deleverage, as savings rates have risen to over 5%, from almost zero a year ago. Whether this is a temporary improvement or a secular shift is hard to say. What is clear, however, is that adding leverage (mostly through home equity loans and credit card debt) allowed personal consumption to grow about a percentage point faster than personal incomes since the last recession in 2001, thereby driving GDP growth at an unsustainable rate. If deleveraging continues, it will have the reverse effect, limiting consumption to a more sluggish pace and taking some of the pressure off prices.
- ***Productivity:*** The key to limiting the inflationary effect of wages is productivity, and in that respect the news is favorable. The Labor Department recently announced that nonfarm business productivity rose 1.6% in the first quarter despite the precipitous 7.6% drop in overall output during the quarter. This development is most unusual during a period of negative economic growth because corporations are normally unable to lay off workers or reduce hours at a pace faster than revenues are declining. This time, however, they have been quick to act. As Americans are painfully aware, six million jobs have been lost in the last year, almost doubling the unemployment rate, and it will take a long time for those jobs to be restored. In an economic upturn, companies are slow to re-hire because it takes time for them to become convinced that growth is resuming. Productivity gains in the recovery phase therefore should help dampen inflationary pressures, at least for awhile.

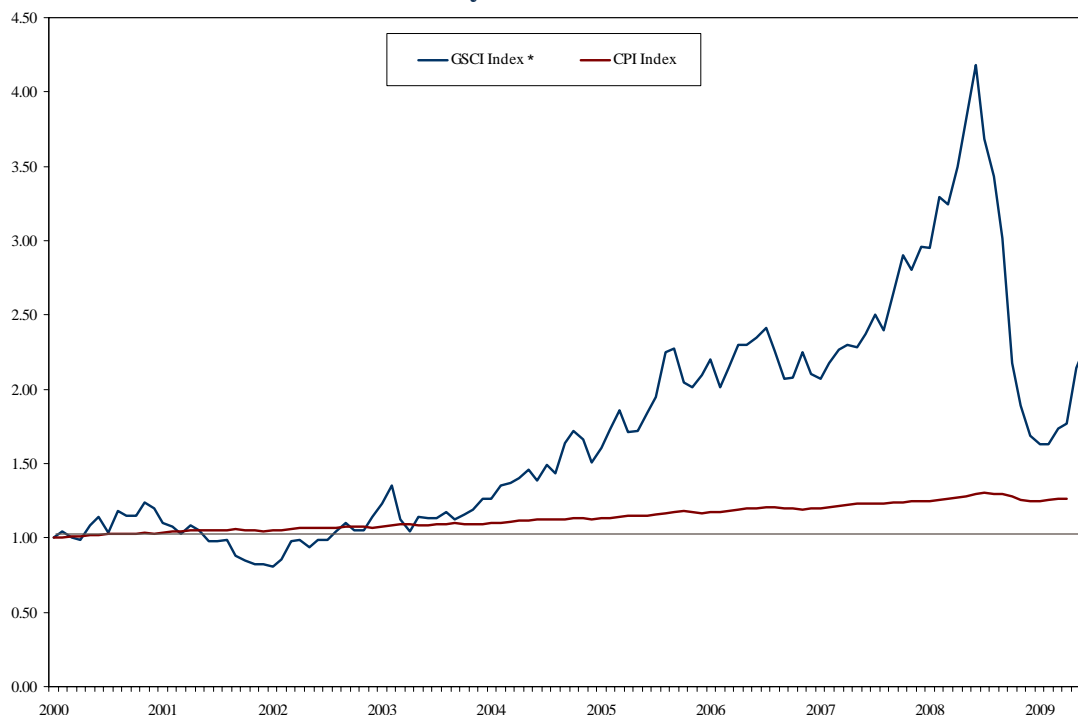
Reasons for Concern

At the same time, there are sound reasons to project a resumption of inflation at some point in the next few years. Because of the time it may take for these forces to take hold, it's difficult to predict when this will occur and to what extent, but it seems highly likely.

- ***Monetary easing:*** As every investor knows, the Federal Reserve has resorted to massive policy easing as a means to saving the financial system from a total meltdown. In addition to extending credit to financial institutions and reducing short-term interest rates to practically zero, the Fed has been buying Treasury securities to monetize the federal deficit. The annual deficit is expected to reach nearly \$2 trillion this year and next, and is likely to remain at \$1 trillion or so for the next ten years. Even though the Fed has dramatically expanded its balance sheet, much of the added money is not getting into the financial system because lenders are still reluctant to lend and borrowers to borrow. In other words, the "velocity" or turnover of money has declined and along with it the "multiplier" effect by which each incremental dollar of money supply increases economic activity by several dollars. At the moment, the Fed's efforts are not inflationary because of the decline in velocity, but there is definitely a risk that when velocity eventually picks up the added money supply will find its way into the system and drive inflation higher.
- ***Stimulus after-burner:*** The \$787 billion federal stimulus package is likely to accelerate the recovery process. Only about 5% of the package has been spent, however, as most programs take time to go into effect, so the rest is yet to come. With most economists calling for the recovery to start sometime in the second half of this year, the stimulus program could serve as a kind of after-burner, contributing to inflationary pressures.

- **Commodities:** Raw materials prices are rising again and are likely to rise further, as the economy gains momentum. Recent gains, particularly in oil, appear to anticipate the recovery as well as reflect growing demand in certain parts of the world, notably emerging economies. Certainly, supply/demand relationships were tight before the recession started, and when global economies return to pre-recession levels they will be again. Since emerging markets are expanding faster than the rest of the world (and experienced a briefer downturn), and since these economies tend to be more materials-intensive, they are likely to keep upward pressure on commodity prices. Still, it's important to note that commodities are not the primary driver of inflation, as shown in the chart below.
- **Dollar weakness:** The dollar's decline is adding to inflationary pressures in the U.S. because it now costs more to import most goods and services. In effect, we are importing inflation.

Commodity Costs and the CPI



Source: Standard & Poor's, Bureau of Labor Statistics

*Goldman Sachs Commodity Index

Clearly, the forces leading up to the financial crisis last fall were severe and deep-rooted, and the fiscal and monetary measures to avert a worse situation have been unprecedented. When you consider that it took several years of high interest rates (peaking at 20%) to break the back of the late 1970s inflation resulting from a much milder set of stimuli than are being applied currently, it would stand to reason that it may take awhile to deal with the inflation that's likely to stem from today's bold measures. The federal debt left by the stimulus program and previous deficit spending is now in the neighborhood of \$10 trillion, and eventually the government will need to deal with it, at least to some extent. Essentially, there are only three ways to reduce the debt load:

- *Grow our way out:* unlikely in the near term, given what we've said about deleveraging and the savings rate.
- *Inflate prices in order to pay down the debt with cheaper dollars:* undesirable and against stated public policy.
- *Monetize the debt by having the Fed buy more of the debt, exchanging money for Treasury securities:* also undesirable as it normally leads to increased inflation.

Some combination of all three is the most likely outcome, which means that inflation will become an issue sometime in the next several years. With so much slack in the current environment, we doubt that it will be much of a problem near-term but it's something that concerns us as we think about asset allocation and security selection within our various portfolios.

Investment Positioning

We suspect that the capital markets will remain somewhat volatile over the next year or so as the forces of inflation and deflation ebb and flow. Market leadership is likely to swing back and forth among various sectors and even asset classes as perceptions about inflation and the pace of the recovery evolve.

The bond markets have recently begun to reflect the prospect of recovery and the long-term possibility of increased inflation. The yield curve has steepened considerably as long rates have risen, presumably in anticipation of a turnaround in the economy. Moreover, the yield on the ten-year Treasury bond increased nearly two percentage points in the six months ended mid-June, and bond futures suggest that the chances of the Fed's tightening by November are over 50%, up from almost nothing a few weeks ago. We may be witnessing a return of the "bond vigilantes" —global investors who demanded higher yields on Treasuries when inflation fears appeared in the late 1970s and 1980s.

In light of these prospects, we have kept maturities in our bond portfolios relatively short. Although this is largely consistent with our normal practice, so as to limit interest rate risk and price volatility, we are particularly sensitive to holding longer-dated bonds if interest rates rise significantly, as they easily could at some point. Another approach is to use Treasury Inflation-Protected Securities as a hedge against inflation since they adjust the return to include the actual amount of inflation over the course of a Treasury bond's life, in addition to the nominal yield. Current prices of these securities imply that inflation will be about 1.6% over the next five years and 1.9% over the next ten years—in line with the Fed's long-term objective but overly optimistic in our opinion. In this connection, it's worth pointing out that inflation data may be somewhat distorted over the next few years, so TIPs may not be particularly attractive in the near term. The largest component of the Consumer Price Index is "owner's equivalent rent," a statistic designed to measure, on a monthly basis, the change in a homeowner's "implicit" rent—or the *economic* value of the shelter services of a home. To the extent that home prices have fallen and are likely to remain depressed for some time (yet the actual cost of an *owner's* occupying his or her home is not actually declining), this component of the CPI may artificially disguise the inflation that many consumers experience in the form of rising raw materials prices. Thus, the inflation factor that adds to the return on TIPs may lag real price changes.

A second approach to enhancing portfolio returns in the slow-growth/inflationary environment we foresee is to increase one's exposure to small-cap growth stocks and certain segments of private equity. When inflation is high, it's important to own assets that can achieve high nominal returns. Small growth companies, both public and private, tend to be less tied to the broad economy than large and/or cyclical ones because they are more dependent on innovation. Creating a new product or service allows them to displace existing ones based on superior performance or pricing, or both. In addition, small stocks normally do better coming out of a recession. The combination of an economic tailwind and innovation allows them to produce earnings growth well above the market averages. Such a tendency isn't just theory: in the last slow-growth/high inflation environment in the late 1970s, small-cap growth stocks out-performed the large-cap S&P 500 index by ten to fifteen percentage points—an extremely wide margin.

Similarly, venture capital and mid-market buyouts can be very profitable in periods like the one we may be entering. The same concept of driving rapid growth through innovation applies, but in addition valuations in private equity are under pressure now, providing an opportunity to profit from both strong fundamental growth and an increase in values. Private equity firms that have recently raised capital should have an advantage in an environment of tight credit, and the slowdown in funding new ventures should mean that the quality of deals improves for those who have capital. It's no accident that funds launched in vintage years corresponding with recessions (e.g., 2001) generally produce exceptionally high returns.

Finally, it may pay to own traditional inflation hedges, such as commodities and real estate if inflation picks up. When commodity prices plunged last autumn and over the winter, we added several stocks with commodity exposure (oil, natural resources) to our portfolios to take advantage of what we thought were extreme conditions. We continue to monitor additional stocks for appropriate entry points in terms of valuation. Emerging markets, particularly those that are resource rich, may warrant additional weighting in portfolios as they are suppliers of certain commodities that may benefit from higher prices over the long-term. In real estate, because of the oversupply and financing turmoil in the sector, there are numerous opportunities to buy property at bargain prices. Those with ready cash can largely dictate terms. We have invested in several real estate partnerships that raised substantial capital to invest in the current distressed environment, and they are beginning to commit funds selectively to the market. We expect the returns to be strong as inflation raises values and the recovery, though tentative, gradually improves the underlying fundamentals.

William L. Paternotte, CFA



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