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# Quarterly Newsletter

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## ~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

Recently, I reviewed a research report which began with the declaration, "In the last year or so, we have seen many negative topics dominate the headlines: unwinding of the Yen carry trade, housing bubble, credit crunch, demand destruction, rising oil prices, and now stagflation." No wonder investor sentiment is so low and market volatility is so high!

In this piece, I want to discuss stagflation, an economic environment characterized by slow to no growth accompanied by higher inflation. The last time the U. S. economy experienced stagflation was during the 1970s. It followed the creation of a huge national debt, which resulted from the "guns and butter" economic policies of the late 1960s, and the expansive monetary policy of the early 1970s engineered to pay for OPEC oil.

In this decade, the parallels are obvious. We have pursued two costly wars while accelerating the growth of government spending, simultaneously cutting taxes. On top of this, the recent effort to save the global financial system has forced the Federal Reserve, and other global central banks, to create an enormous amount of excess liquidity. It is this excess liquidity which threatens to drive inflation.

Some worry that inflation is a function of rising commodity prices due to speculation. This just isn't so. The rising price of commodities, whether it is oil, metals, or grains is partially a reflection of the debased value of the dollar, but it is also a reflection of constrained supply failing to keep up with increased demand. Speculation can only impact prices on a very temporary basis; mostly it simply serves to dampen price volatility.

In an era of stagflation, some investments tend to perform better than others. During the 1970s, those companies which performed best had one of two characteristics, either they were rich in assets or they were characterized by "unit growth." Unit growth, now called organic growth, simply means that there is growing market demand for, and a company has the ability to increase its output of goods and services. Then, as now, the best example of this is found in the technology sector. Companies rich in assets benefit from inventory profits.

In a time of stagflation, the companies that tend to underperform are those which extend credit at a fixed rate and those which rely on credit with rising interest costs to leverage profitability. Similarly, consumer spending suffers when credit tightens and rates rise. Another investment that suffers in an inflationary environment is long bonds. As interest rates rise, long maturity bonds will decline in value, reflecting the need for investors to be compensated for the lower purchasing power of their future cash flow.

While the media tends to describe the economy in stark contrast, giving the impression of rapid change, the reality is quite different. The excess that is currently being worked out of the system took a long time to reach this state and it will take a long time to work off. So far, the Federal Reserve, under the leadership of Ben Bernanke, has done a good job of wringing out this excess, without destroying the global financial system. ***There is still a long way to go before we can put this correction completely behind us, but as financial markets tend to anticipate the economy, we think the rewards far outweigh the risks from long term investments at this time.***

## Fixed Income Update - Stay with Quality

Bond market interest rates rose during the second quarter, as the Federal Reserve appears to have stopped lowering the short-term rates that it controls and bond investors began to worry about higher inflation.

While rates on U.S. Treasury bonds increased the most, they are still low relative to other types of bonds and the most vulnerable to an increase in inflation. Therefore, we are focusing our bond holdings on high-quality alternatives.
On the taxable side, we continue to buy U.S. government agency bonds (Federal Home Loan Banks and Federal Farm Credit Banks). Callable agencies are still a good deal in many cases. We have bought some corporate bonds as well. We are cautious on buying additional bonds of financial companies for the moment, as the mortgage and credit environment is still negative and it is difficult

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to predict how severe it will ultimately get. We are looking for good-quality issuers in the industrial and utility sectors.

On the tax-exempt side, yields have also been rising, although not as much as for taxable bonds. However, tax-exempt municipal bonds still yield as much or more than Treasuries for nearly all maturities, a highly unusual situation. Again, we advocate staying with the higher-quality issuers, as the stresses on the financial system may create problems for municipalities with low financial reserves.

We are still keeping portfolio maturities relatively short, as the potential for increasing inflationary pressures still exists. This would put pressure on the prices of long-maturity bonds. However, rising rates have already begun to give us opportunities in the 2-5 year maturity range.

Some of the lower-quality corporate and municipal bonds have seen sharply increasing yields, well into the double digits in many cases. However, we would not be tempted to bottom-fish in these bonds, as the probability of some high-profile defaults continues to increase. ***We would also remind our clients that the primary purpose of fixed income holdings in our portfolios is to provide diversification and increase portfolio stability, an objective better achieved with higher quality bonds.***

## International Equity - Black Gold Rules

Over the past few years, international equity markets, represented by the MSCI EAFE and EM indices, have substantially outperformed the S&P 500 and handsomely rewarded U.S. investors. Unfortunately, that era seems to have come to an end; year-to-date, these indices have declined in line with the S&P 500.

Examining the returns by region reveals that emerging market Latin American has performed the best with an 8 percent gain, led by Argentina and Brazil. Emerging market Asia lagged the most with a 23% decline, dragged down by China, India and Vietnam, a country which, until recently, was popular with the Chinese and Taiwanese investment community. ***This recent market action confirms our rationale that currently, countries rich in natural resources are likely to outperform countries dependent on manufacturing but poor in essential commodities.***

In general, commodities have been a critical factor in determining equity performance but crude oil, perhaps the most important commodity of all, continues to set record high prices. It is absolutely crucial to understand the factors which determine high oil prices. The reasons that oil prices are high are generally attributed to speculation, geopolitics, the weakening U.S. dollar, and concerns about future supplies. While speculation can sometimes be driven by emotion, that is not always the case. In the current environment there are highly leveraged commodity funds that can sometimes amplify what, under more normal circumstances would simply produce a temporary disequilibrium between supply and demand.

Geopolitics has always exerted a significant influence on crude prices. The recent confrontation over Iran's nuclear program by the U.S. and Israel has been heating up. Tensions are rising in the region, amid speculation that Israel may be prepared to attack Iran, OPEC's second-largest oil producer, to prevent it from building a nuclear bomb. In response, Iran's Revolutionary Guard has threatened to shut the Strait of Hormuz. The Strait of Hormuz is a vital international waterway that transits more than 90 percent of all oil exported from the Persian Gulf, or nearly two-fifths of the world's oil supply. Effectively shutting Hormuz would have a significant impact on world energy markets; and very likely, bring the already skittish world economy to its knees.

The weak U.S. dollar has been blamed in part for skyrocketing crude prices and that is not likely to reverse soon, considering the divergence of interest rate policy between the Federal Reserve Bank and other central banks. Faced with rising inflation, many countries' central banks have raised their benchmark rates; most recently, the ECB raised interest rates for the first time in more than a year to stem inflation even as economic growth slows. The Fed, unlike the ECB which seems only concerned with the task of controlling inflation, is simultaneously attempting to prevent a recession. With the recently released weak job market data, and this an election year, it is widely believed that the Fed is not going to raise rates anytime soon. If so, it will be difficult for the dollar to strengthen.

Future availability of crude oil is a valid concern since reserves are more difficult to find and more expensive to develop. But, politics also plays a significant role for developing a reliable supply of oil. "The world has as much as 5 trillion to 7 trillion barrels of oil yet to be developed located in challenging areas," Ali al-Naimi, Saudi Arabian Oil Minister said at the World Petroleum Congress, "the limits to future supplies have more to do with politics than with geology and resource availability."

Even with the price of gasoline quickly approaching $5 a gallon, we think crude oil, and other essential commodities, will continue to trade at high prices until a slowing global economy begins to decrease demand. In this context, we will continue to place emphasis either on companies rich in natural resources or with a cost structure insulated from high commodity prices.