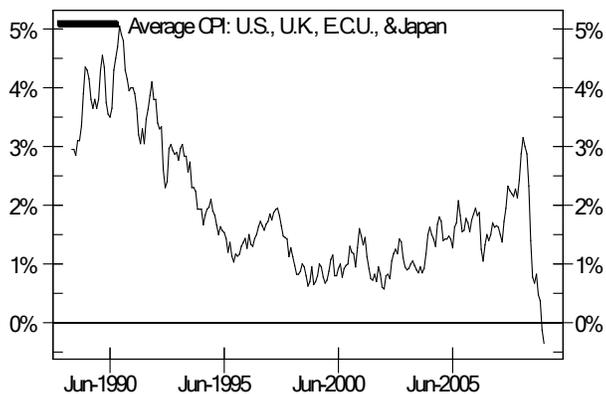


The Great Inflation Debate

Without question, one of the most important issues facing investors right now is the outlook for inflation. In addition to its impact on the purchasing power of future returns, inflation is a key determinant of the level of interest rates, equity market valuations and the foreign exchange impact on returns from international allocations. As such, the outlook for general price levels in the broad economy is always a critical element in determining the optimal policy mix. The current environment, however, is different. Never before has the range of potential inflation outcomes been so large.

The declines in real estate, equities, corporate bonds, and other risky assets have created massive deflationary forces. In addition, job losses and production cutbacks have created a tremendous amount of excess capacity which also puts downward pressure on the price of goods and services. As illustrated in the chart below, consumer prices in developed countries have now entered deflationary territory for the first time in at least 70 years.

Consumer Price Inflation

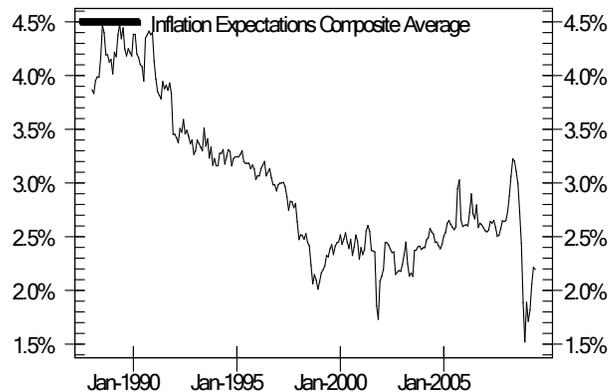


Sources: Bloomberg, DHJA Research

Challenging this deflationary outlook, however, is the massive amount of liquidity that has been created by the Federal Reserve. As of July 9th, the Fed's balance sheet totals just over \$2 trillion, a near doubling from the \$1.1 trillion reported just 12 months ago. If Milton Friedman's creed is correct ("inflation is always and everywhere a monetary phenomenon"), we are destined to experience a very high rate of inflation over the next ten years.

The net result of these two opposing forces is a widely divergent set of expectations for future inflation. The following chart displays a proprietary indicator that we have used for many years to monitor inflation expectations. As shown, expectations collapsed in the second half of 2008 from above 3% to 1.5%.

Inflation Expectations



Sources: Bloomberg, DHJA Research

While the current level of 2.2% may suggest there is little risk of significant inflation or deflation, this is much like having one foot in a bucket of ice and the other in a bucket of boiling water: your body temperature may appear comfortable 'on average'. The dispersion of inputs to this indicator (including, among other variables, market yields, professional forecasts, and consumer surveys) are much wider than normal. This reflects the divergent set of expectations that results from very large inflationary and deflationary forces occurring simultaneously.

It appears that the general public, at least as measured by the mainstream media, is much more interested in inflation than deflation. Using Google, a search for the term 'inflation' in news articles this year yields about 83,000 hits, while a similar search for 'deflation' returns just under 10,000 hits.

Over the longer term, these fears are certainly not unjustified. The Fed's dramatic injections of liquidity will be inflationary if they are not removed from the banking system at the appropriate time. The 'appropriate time', in turn, depends on an accurate forecast of bank lending, housing prices, and a recovery in broad economic activity. This is clearly a challenge. Can a Federal Reserve that completely missed the housing crisis, and as recently as mid-2007 thought that it would be 'contained', really forecast these variables accurately?

In the near term, however, we may well see deflationary forces prevail. The Fed's monetary stimulus remains primarily within the banking system, excess capacity abounds, and residential and commercial property values continue to decline. These forces are very deflationary indeed. Although accelerated inflation rates seem inevitable, they may be delayed for longer than may analysts believe.

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