

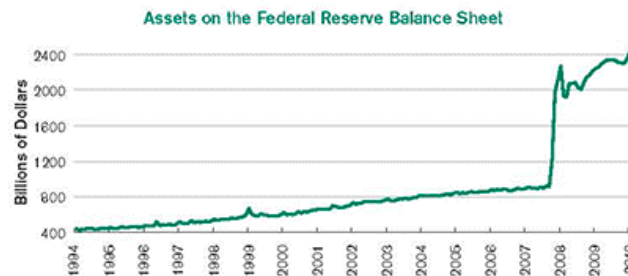
The Inflation Situation

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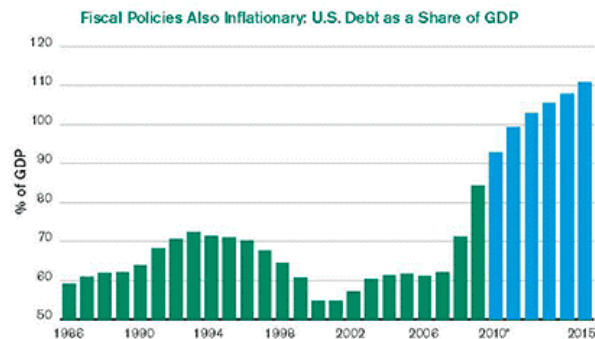
As every trip to the gas station and grocery store seems to get more expensive, it comes as no surprise that the issue of inflation continues to move toward the forefront of thoughts on the economy. We thought it an opportune time to share with you our perspective on the situation and the effects of inflation on the management of your investment portfolio.

Like so many issues confronting our economy, inflation and its impact going forward is a rather complex issue to examine. On one hand, there are several forces that appear poised to drive inflation higher in the days ahead:

1. Monetary policy: The Fed's ultra-accommodative policy has kept the Fed funds rate at zero for quite some time and the Fed's balance sheet has grown to epic proportions.



2. Fiscal policy: As a by-product of stimulus designed to push economies out of recession, deficits of both the U.S. and other developed countries are at record high levels. Interest costs on debt and entitlement spending look to be causes of major deficits going forward.

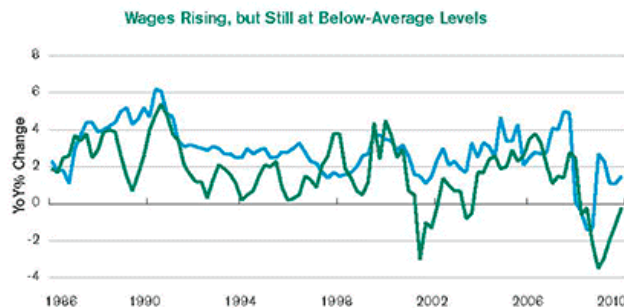


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3. Weak dollar: A weaker dollar results in higher costs for imported goods which does not bode well given the U.S. trade deficit. To make matters worse, commodities are priced in dollars making them more expensive to Americans and cheaper to holders of other currencies which could potentially increase demand elsewhere, sending prices higher.
4. Emerging markets growth: Until recently, emerging economies represented a small portion of the global economy. These economies now have a significant impact on commodity demand and are experiencing positive wage growth. Inflation is alive and well in emerging markets.

On the other hand, there are several other forces at play that are keeping excessive inflation in check:

1. Lack of wage pressure: When jobs are plentiful workers can command higher wages (think supply vs. demand) and companies must pass along price increases to consumers, setting off a difficult inflationary cycle. The current high unemployment rate has prevented such compensation increase demands on the part of the worker.



2. Excess manufacturing capacity: The Great Recession slowed down manufacturing in the U.S. and elsewhere. Recent studies show that one quarter of U.S. industrial capacity is unused. An increase in demand for U.S. produced goods could therefore be met with ample manufacturing capability without the expense of further factory and personnel build-out whose costs get passed on to the consumer.
3. Housing: Falling home prices over the last few years have played a significant role in tempering inflation. In fact, housing represents 43% of the CPI, the most widely used measure of inflation. The breadth of the housing slowdown impact on jobs is enormous and extends to hundreds of industries. In fact, some estimates are that one million jobs have been permanently eliminated as a result of the bursting of the housing bubble.
4. Less economic impact from energy: As the American economy has moved from a manufacturing focus toward one of a service-based economy, the impact of energy prices on the economy has been subdued as well. As our economy no longer derives such a large percentage of output from industrial activity, no longer does a run-up in oil prices translate to a potential severe setback.

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Moreover, overall fuel efficiency has been improved dramatically over the last few decades. While we may feel pain at the pump after an oil price increase, the aggregate effect on GDP is not nearly what it was a few decades ago.

Clearly, there are several forces at play, some inflationary and some deflationary. We believe that, over time, the aforementioned issues that threaten to drive inflation higher, will win out. The timing and extent are difficult to predict, however. Historically, inflation typically lags economic recovery by about two years. The Fed seems comfortable with current levels of inflation, but we have positioned portfolios defensively should the issue continue to escalate.

As always, we maintain that a balanced and diversified approach to portfolio construction is the best bet. In a low and rising inflation environment, bonds historically take the largest hit and equities and commodities do well. We do feel that bonds have a critical place in our portfolios, but have strategically focused on short-term bonds that are less exposed to the effects of rising inflation and interest rates. Additionally, we have incorporated floating-rate bonds and even short positions in Treasuries as areas where we can effectively hedge against rising rates, if not profit. On the equity side, we are underweight in those areas we feel are overvalued such as small caps and large cap value and emerging markets where inflation is already proving to be a problem. We maintain some exposure to commodities both through alternative investments such as our energy pipeline allocation and indirectly through some of our other equity holdings.

Please feel free to contact us (404.874.6244) if you would like to discuss the inflation issue further and how it relates to your portfolio. We appreciate the confidence you have placed in us and welcome the opportunity to speak with anyone who may benefit from our services.

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