

# INFLATION PRIMER

July 2009

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# MACROECONOMIC INFLATION ARGUMENT

# THE ARGUMENT FOR

- **Increased Liquidity**

- ❖ Conventional wisdom says that inflation is caused by too much money chasing too few goods. Therefore, the Fed's massive injection of liquidity into the financial system could lead to substantial inflation.

- **Deficit Financing**

- ❖ The federal government's economic stimulus program is producing record-high budget deficits. This massive increase in spending is potentially inflationary.

- **Commodity Prices**

- ❖ Global demand, especially from China and other emerging Asian countries, may boost commodity prices, pushing inflation upward.

- **Falling Dollar**

- ❖ If foreign investors lose confidence in U.S. policies, the dollar could drop, making imports cost more, and inflation could accelerate.

# MITIGATING FACTORS

## • **Increased Liquidity**

- ❖ The increase in money supply will be offset by a slowdown in the velocity of money. People are holding more money, as indicated by rising savings rates.

## • **Deficit Financing**

- ❖ When an economy is operating with unemployed resources, deficits will tend to generate more real output rather than inflation. Only when the economy is at full capacity is it hard to meet extra demand with supply, so prices go up.
  - Evidenced by the late 1960s when unemployment was at 4% and Johnson/Nixon ran deficits to fund social programs and Vietnam.
- ❖ A high unemployment rate means that there is no shortage of labor, and wage inflation will remain low. With so much excess capacity, demand could increase without creating shortages.

## • **Commodity Prices**

- ❖ Even as oil spiked to \$145 last year, core CPI never rose above 2.6%; thus, wages effect prices much more than energy.

## • **Falling Dollar**

- ❖ Expansionary fiscal and monetary policies of trading partners creates weakness on behalf of other currencies as well.
- ❖ Trading partners have a strong incentive to prevent a collapse.

## • **Other**

- ❖ History shows that inflation is influenced more by credit growth than money supply growth, and credit is still tight despite the increase in money supply.

# CAPTRUST INFLATION STUDY

CapTrust surveyed 40 large and well respected separate equity and fixed income managers to assess their thoughts on the probability and impact of inflation\*. The general consensus is summarized below.

## • Severity

- ❖ 15% of the managers are forecasting a hyperinflationary environment.
- ❖ 67.5% of the managers expect low to moderate inflation.

## • Timing

- ❖ Short term deflationary pressures should mitigate inflation.
- ❖ 67.5% of the managers expect that inflation will not likely appear in earnest for 2-4 years.

## • Effect on Securities

- ❖ 60% of the manager comments suggest that overall allocation should favor equities, as the impact of inflation would likely be more detrimental to fixed income.

## Manager Survey Quotes

“We believe that some level of inflation is inevitable when the global economy begins to recover. We believe that this inflation will be manageable, based on our confidence in and level of cooperation between various central banks and the “wobble room” available given the extremely easy nature of current monetary policy.”

- Riverpoint, Domestic Equity Manager

“In a fractionalized banking system, banks create money not the Fed. If the banks aren’t lending, money is not getting to the end user, the consumer, and inflation is not a major concern over the next 18 months.”

- Munder Capital, Fixed Income manager

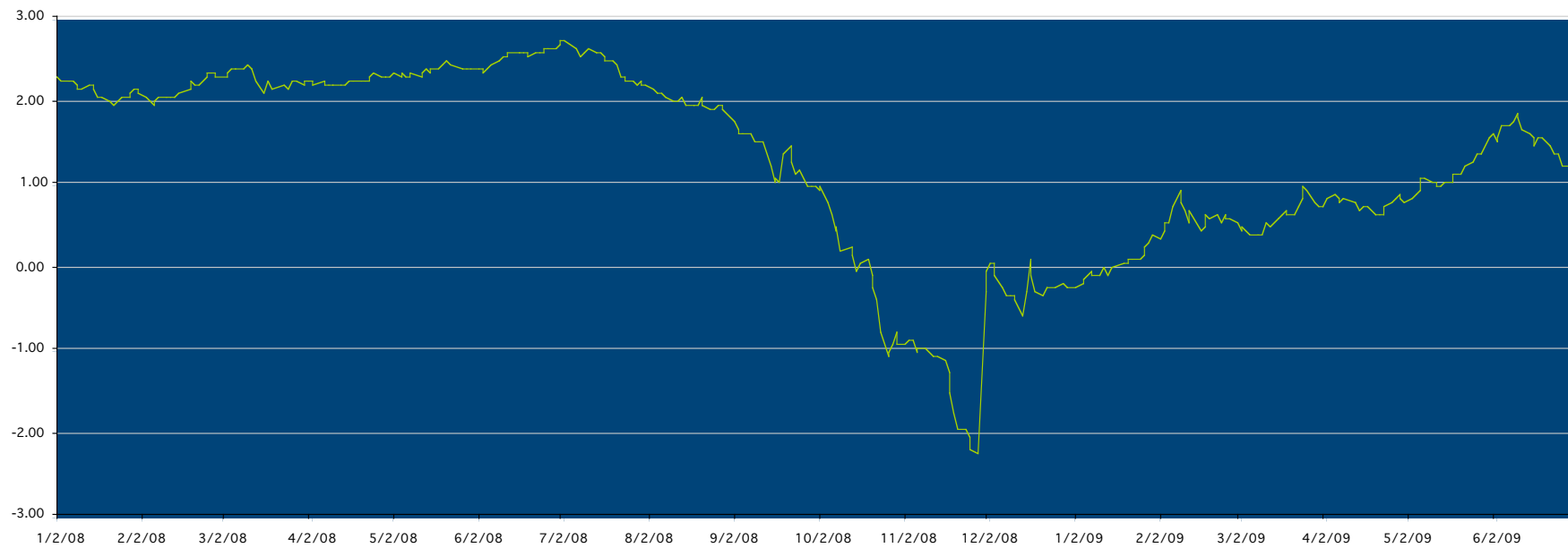
“Stocks traditionally have held up better than bonds during inflationary periods due to their ability to capture inflation’s effects in their revenue streams, ensuring growth in an inflationary environment.”

- Artio Global, International Equity Manager

\* See Appendix for summary of survey responses.

# 5 YEAR IMPLIED INFLATION

5 Yr Implied Inflation

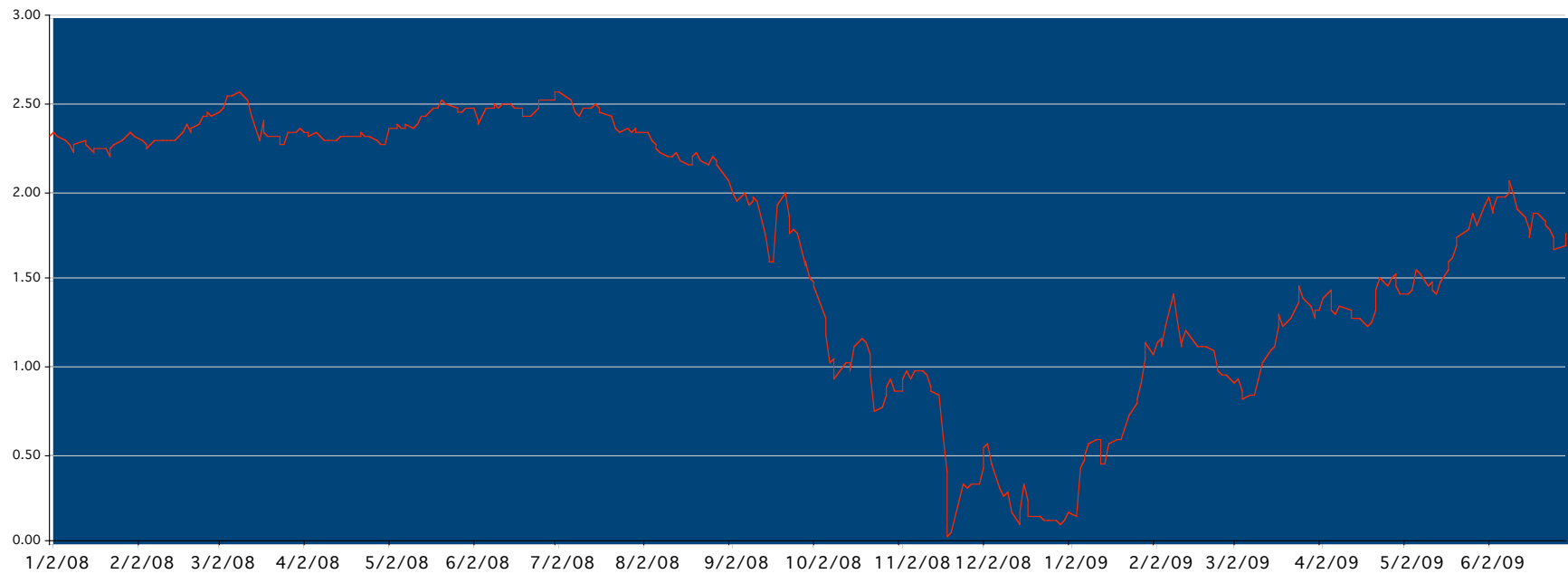


The “Market Implied Breakeven Inflation Rate” is the rate at which an investor is better off holding TIPS over a conventional Treasury. It can be computed by subtracting the yield to maturity of the TIPS from the yield to maturity of the corresponding Treasury.

Source: CapTrust and U.S. Department of Treasury

# 10 YEAR IMPLIED INFLATION

10 Yr Implied Inflation



The “Market Implied Breakeven Inflation Rate” is the rate at which an investor is better off holding TIPS over a conventional Treasury. It can be computed by subtracting the yield to maturity of the TIPS from the yield to maturity of the corresponding Treasury.

Source: CapTrust and U.S. Department of Treasury

# IMPLICATIONS

- **Equities**

- ❖ Favor international equities over domestic.

- **Fixed Income**

- ❖ Favor individual issues with maturity dates versus perpetual vehicles (funds).
- ❖ Shorten fixed income maturities.
- ❖ Diversify fixed income to include higher yielding and international holdings.

- **Introduce Dedicated Strategies**

- ❖ CapTrust prefers:
  - Liquidity
  - Transparency
  - Reasonable Fees
  - Income
  - Volatility less than or equal to equity markets

- **TIPS** (Treasury Inflation Protection Securities)
  - ❖ **Pros:** Simple, transparent and inexpensive hedge in lieu of traditional bonds.
  - ❖ **Cons:** More volatile than traditional bonds. If too early, deflationary pressure could result in principle declines.
  
- **Commodities** (Energy, Precious Metals, Agriculture, etc.)
  - ❖ **Pros:** In a flat economy, hard assets such as commodities retain their purchasing power relative to paper currency. Commodities, therefore, historically provide a direct hedge against inflation.
  - ❖ **Cons:** Commodities offer no yield so adding them to an allocation detracts from other investments that provides current income.
  
- **Real Estate**
  - ❖ **Pros:** Real estate has many of the same benefits of other hard assets. Real estate has historically kept pace with inflation due to the ability to increase rents commensurate with an expanding economy.
  - ❖ **Cons:** Real property versus REITs represents more of an illiquid asset and one that requires expertise in the local markets.

## CONCLUSIONS

# CONCLUSIONS

- **Increase inflation hedged positions by year end.**
  
- **If underweight equities, continue rebalancing with objective to reach target allocation by year end.**
  
- **By major asset class:**
  - ❖ **Equities**
    - Maintain target weightings for equities
  
  - ❖ **Fixed Income**
    - Move from funds to separate accounts if necessary
  
  - ❖ **Inflation-related strategies**
    - Initiate positions by year end

# APPENDIX

# INFLATION SURVEY SUMMARY

Managers	No or Limited Concerns	Inflation IS a concern			Projected Inflationary Environment			Effect on Bonds		Effect on Stocks	
		0-1 years	2-4 years	5+ years	Low	Moderate	Hyper	Negative	Positive	Negative	Positive
<b>Domestic Large</b>											
Bahl & Gaynor			x								x
Chicago Equity	x				x			x		x	
Crawford			x		x			x		x	
Fayez			x			x		x		x	
Friess	x				x			x		x	
GE Asset Mgmt			x		x			x			
Navellier			x			x		x			x
NFJ	x							x			x
Riverpoint			x		x			x		x	
Seizert			x			x		x		x	
Valley Forge			x					x			x
<b>Domestic Small/Mid</b>											
Diamond Hill			x					x			
SouthernSun			x			x		x			
Cramer Rosenthal	x				x			x		x	
TS&W	x				x			x			
Westfield	x				x			x		x	
Daruma			x		x			x			
Fred Alger			x		x						
LA Cap		x						x		x	
Fisher			x			x		x		x	
Lord Abbett			x					x		x	
<b>International</b>											
Artio Global			x		x			x			x
Capital Guardian	x		x		x			x			x
Lazard	x	x			x			x			
Manning & Napier	x										
Northroad		x				x		x			x
Franklin Templeton	x							x		x	
Tradewinds		x						x		x	
Wentworth, Hauser, & Violich			x					x			x
Harding, Loevner			x			x		x		x	
<b>Fixed Income</b>											
BlackRock	x			x	x			x		x	
Boyd Watterson	x		x		x			x		x	
Chicago Equity	x		x		x			x		x	
Munder	x		x		x			x		x	
NISI	x	x				x		x		x	
PIMCO	x		x			x		x		x	
Richmond	x			x	x			x		x	
Wasmer	x			x		x		x		x	
<b>Alternatives</b>											
Stonebridge	x		x			x		x		x	
Lateef	x		x			x		x		x	

Responses	20	5	22	3	18	11	6	35	0	23	7
Count	40	40	40	40	40	40	40	40	40	40	40
Percentage	50.00%	12.50%	55.00%	7.50%	45.00%	27.50%	15.00%	87.50%	0.00%	57.50%	17.50%

## Survey Details:

- The Survey was conducted between April 30, 2009 and June 30, 2009.
- Managers that CapTrust had a relationship with during the time of the survey were selected for participation.
- Questions were sent directly to the management firm and the individuals responding were at the discretion of that firm.
- The following questions were asked to the management firms:
  - What are your thoughts on the likelihood and severity and timing of inflation in the future?
  - In your opinion, what would the effects of a high inflationary environment have on bonds?
  - In your opinion, what would the effects of a high inflationary environment have on stocks?
  - In your opinion, what would the effects of a high inflationary environment have on the stock and bond allocation decision?
  - If inflationary pressures are a concern, are you doing anything differently in your strategy to prepare for this environment? If so what?
  - Outside of the inflation questions what other areas of concern does your firm have?
- The survey results on the previous page is CapTrust's summary of the manager responses to the above questions.
- Full responses from investment managers are available upon request.