

# the Whitepaper

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## Burt White

Chief Investment Officer  
LPL Financial

### Highlights

#### Inflation or Deflation — Where is the Fed Focused Right Now?

- While above trend inflation is historically negative for the markets, current low levels of economic growth signal there is no real concern that inflationary pressures are going to take hold anytime soon
- Deflation, on the other hand, is a much bigger concern for the central bank as the fragile economic recovery doesn't need any negative price pressures

#### The Fed and Continued Economic Growth — What Can They Do?

- With the Fed Fund rate hovering between 0% and 0.25%, the Fed has little to no room to boost economic growth through lowering interest rates
- The Fed can engage in a second round of quantitative easing (QE2) which injects massive amounts of liquidity into the system

#### Who are the Winners and Losers if the Economy Reinflates?

- Quite a few sectors benefit as the economy begins to reflate — gold and commodities, TIPS, Emerging Market Bonds, and Real Estate, to name a few
- Conversely, the dollar and Financials tend to underperform during periods of deflation

## Inflating the Economic Growth Tires

The recent transition from summer to fall left me thinking this weekend about some of my best summer memories. There are many, but one popped into my head that likely was triggered by the fact that I spent much of Saturday morning pumping up bike tires for each of my four kids, which, frankly, is a lot of tires.

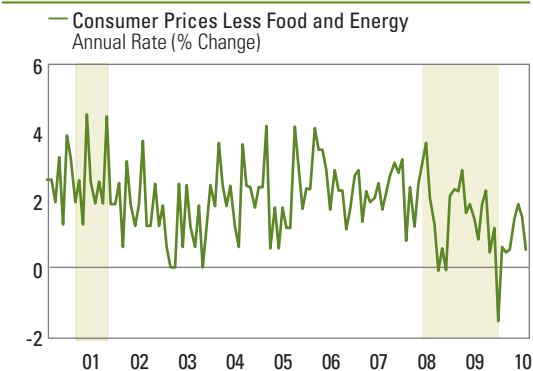
One summer, between my junior and senior year in high school, a few buddies and I decided to take a road trip to go camping, fishing, and whitewater rafting. We all climbed into the huge “boat” of a car that I was lucky enough to drive—a 1977 Oldsmobile. It was orange-brown with cloth seats and faux wood panels on the inside. And, with it loaded down with bikes, tents, coolers, fishing rods, and five teenage passengers, it had an eerily similar look to Clark W. Griswold’s clunker in the movie, *National Lampoon’s Vacation*.

As we were riding through the back roads of West Virginia on the way to our destination along the Ohio River, we ran over a nail and got a flat tire. Pulling over to the side of the road, we tried to remove the nail, but it was lodged too deeply in the tire. The dilemma was that we were 100 miles from nowhere and, worse yet, had no spare tire. In our attempt to pack more coolers and fishing gear, we removed the spare tire from the trunk to make extra room—not the best idea in hindsight.

Obviously, we had no cell phones, as they did not exist yet (and even if they did, our remote location likely would have rendered them useless). So, we decided to split up. One pair would walk ahead looking for a gas station and the other three would try to pump up the car tire using a handheld bicycle pump. I have to say, I still laugh thinking about how hard it was to inflate that tire with the handheld pump. It took 20 minutes, but finally the tire was inflated enough to drive on. We jumped in the car, picked up our “scouts” a few miles down the road, and then made it an extra three or so miles before the slow leak resulted in the tire being flat again.

We ended up doing this about five more times—20 minutes of pumping up a tire for six minutes of driving—until we found a small town with a service station to repair the leak. The ironic part was that the whole theme of that trip was about “inflating,” and we wore that little pump out. In addition to the car tire, it was used countless times for our bikes, rafts, and inflatable mattresses in our tents. To this day, I cannot pick up a pump without remembering the time it saved a few stranded teenagers.

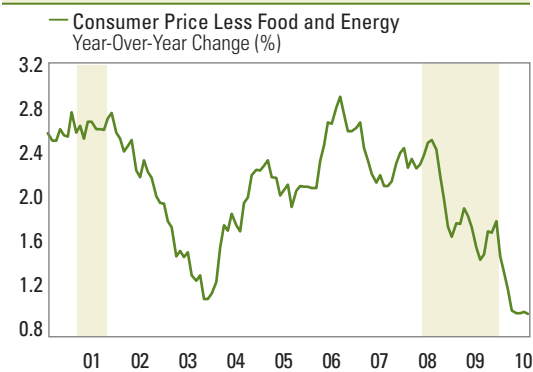
1 Measured Annually or Year-Over-Year...



Source: Bureau of Labor Statistics/Haver Analytics 09/29/10

Shaded areas indicate recessions

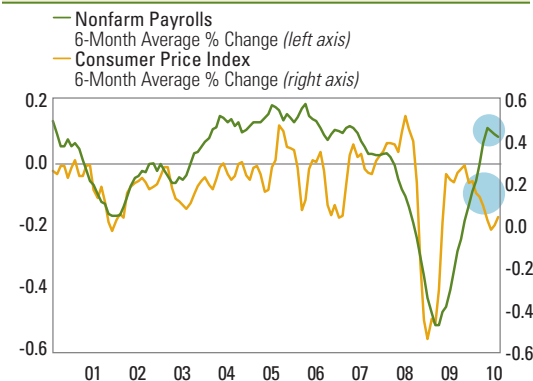
2 ...Inflation is Trending Lower



Source: Bureau of Labor Statistics/Haver Analytics 09/29/10

Shaded areas indicate recessions

3 Strong Employment Requires Some Inflation



Source: Bureau of Labor Statistics/Haver Analytics 09/29/10

Fed Needs a Pump, Too

On Tuesday, September 21, the Federal Reserve Bank (Fed) released its latest Federal Open Market Committee (FOMC) statement. In it, the Fed briefly mentioned a slight downgrade of its view on the economy, but ended up talking quite a bit about the lack of inflation and its negative impact on achieving full employment targets. Specifically, it states, “Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability.” In a sense, what the Fed really said is that the economy has a slow leak in its economic growth tire.

Now I know what many of you are thinking: isn’t inflation bad and what does inflation have to do with employment anyway? High inflation is certainly not optimal, as soaring costs can lead to reduced demand and eventually a recession. But, the U.S. economy is a long, long way from high inflation. According to the Bureau of Labor Statistics/Haver Analytics, inflation is trending lower and is at levels well below the targeted 1.5% to 2% level desired by the Fed [Charts 1 and 2]. Thus, while soaring inflation is bad, modest inflation is healthy.

However, the bigger risk is not soaring inflation, but rather deflation. Deflation occurs when the supply of goods far exceeds the demand for goods and prices are pushed lower. This hurts on two levels. First, excess supply causes manufacturers to reduce production, which leads to plant shutdowns, fewer trucks on the road, and laid-off employees. Secondly, the demand side often enters a “death spiral,” which occurs when consumers see lower prices and thus delay purchases in hopes of even better values. Deflation occurring at this time in a fragile economic recovery would be a disastrous event and could be a catalyst to perhaps enter a second, double-dip recession.

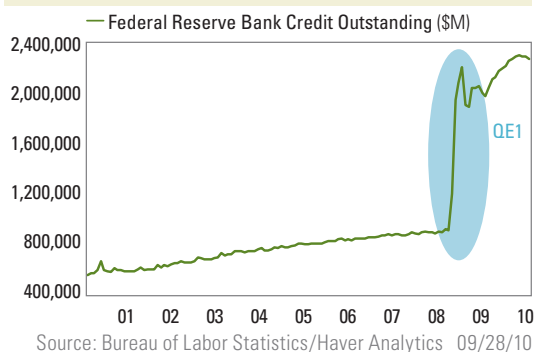
Clearly, we want to avoid the dreaded d-word (deflation), but encountering the i-word (inflation) is no cause for alarm, because inflation is a by-product of growth. In a sense, inflation is the smoke generated by a hot economic growth fire. If the economy was humming along, or even limping along, inflation would be higher than it is now. It is, essentially, like a game of dominos. Greater economic growth means higher inflation, which means greater employment, which means the housing market is better.

Looking at the chart titled Strong Employment Requires Some Inflation [Chart 3] and using the Consumer Price Index (CPI) as a proxy, it is easy to see why the Fed is so worried about inflation. Notice the strong connection between inflation (orange line) and employment (green line). Over rolling six-month periods, the average monthly change in payrolls is closely tied to that of the amount of smoke (inflation) created by the economic growth fire. While employment and inflation rebounded nicely from the depths of the latest recession, recent data shows a down-tick in CPI growth, which is beginning to pull down employment growth, thus exacerbating the housing crisis. Therefore, having our economy achieve some level of inflation is vital, especially for healthy employment and an improving housing market.

## What, if Anything, Can the Fed Do to Increase Economic Growth?

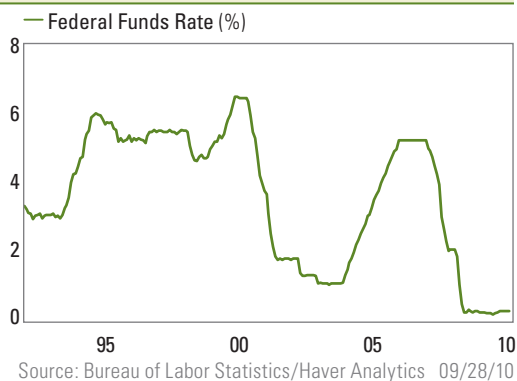
The FOMC statement makes clear that the Fed believes its responsibility is to achieve the appropriate levels of growth (and thus inflation) in the economy. Moreover, by stating, “*Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability,*” the Fed basically is admitting it believes it has not done its job very well. Essentially, the Fed is not grading its performance with an “A.” But despite the lack of success thus far, by referring to “*its mandate*” three separate times in the FOMC statement, it is clear the Fed believes its duty is to do something.

### 4 The First Round of Quantitative Easing Expanded the Fed’s Balance Sheet



So how does the Fed intend on inflating America’s leaky economic growth tires? With interest rates at zero, there is no room for interest rates to spur growth. The most likely scenario would be for the Fed to enact what now is commonly referred to as QE2—the second round of quantitative easing. QE is essentially the Fed expanding its balance sheet by buying up securities (usually Treasuries or Mortgage-Backed Securities) [Chart 4]. The rumor is that the amount intended to be purchased in QE2 is somewhere between \$500 billion and \$1 trillion. The result of these actions would be threefold. First, it takes bonds out of the market (the Fed owns them) and returns cash. Thus, it increases the amount of dollars in the system, which is known as easy monetary policy. The second benefit is that as the Fed buys Treasuries, it raises their prices (greater demand) and thus lowers their yield, which in return lowers mortgage rates, since they are derived from long-term Treasury yields. Third, as yields go lower on Treasuries, investors realize that the interest payments they would receive are just too low and seek riskier investments with higher returns, which props up equity and corporate bond markets.

### 5 Historic Levels of Federal Funds Rate



Sounds like a win-win for everyone, doesn’t it? Well, yes and no. The biggest arguments against QE2 are the following:

1. With yields already at historic lows [Chart 5], can yields really move any lower, and would it really have any major impact if they did?
2. Yields are already low, and, thus, mortgage rates are at all-time lows, but they have not had much influence on improving the real estate market. So, if 4.5% mortgage rates will not get people buying homes, why would 4.25%?
3. Would even lower yields on Treasuries send foreign investors, whom we depend on to finance our debt, running for the hills and actually result in the opposite effect the Fed seeks—that of higher Treasury prices and lower Treasury yields?

At some point, the Fed will have to unwind all of these easy monetary policies. With rates at zero and a ballooning balance sheet at the Fed, imagine trying to unwind this mess. Just how hard will it be to raise rates from 0% to just 2%, let alone historically higher 3% to 5% levels, while at the same time trying to sell a ton (perhaps multiple trillion dollars worth) of Treasuries and Mortgage-Backed Securities? Quite the dilemma. But

regardless of the situation, we have to “live to fight another day,” so maybe these are problems better dealt with another day.

Given the pros and cons of additional quantitative easing, will the Fed actually act? Well, the lack of transparency in the FOMC statement has left the markets quite confused. On one side, the Fed expresses three times “its mandate” to get inflation higher. They actually use the descriptor “its,” referring to itself: the Fed. This signals that the Fed realizes it has not done what it needs to do, but realizes it needs to do something (hence QE2). On the other side, the Fed states “it is prepared to provide additional accommodation if needed,” which is not exactly a reassurance that QE2 is coming anytime soon. After all, being “prepared” and preparing to act are quite different, and stating “if needed” sounds as if the Fed is not even convinced action is required. Quickly re-read this sentence: “The Committee will continue to monitor the economic outlook and financial developments and is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate.” So will the Fed buy a trillion dollars worth of Treasuries over the next few weeks or not? Tricky question, isn’t it? That is what has this market “walking on eggshells” and, frankly, a tad snake-bit.

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Given the level of uncertainty, what is it that we know for sure? The bottom line is that reflation is going to happen, and the winners are anything tied to increasing inflation and anything on the other side of the dollar. Reflation is essentially the intentional act of creating inflation. Think of it as the Fed pumping up a flat economic growth tire, but with such few tools left in its arsenal (as it cannot lower rates anymore), it has to do the inflating using an old handheld bicycle pump.

## Winners in the Move to Reflation

Who are the winners in a reflationary period? Actually, quite a few investments benefit from reflation. This is largely because increased inflation is a by-product of increasing economic growth, which, in turn, benefits many investments. That said, some investments appear to be better opportunities than others.

- **Gold/Silver:** Precious metals are a store of value and an inflation hedge. Despite gold being priced at all-time highs, it is still perhaps the best reflationary investment. After all, both bulls and bears love it at the same time, which is very rare. Bears love gold as a store of value. Bulls love the momentum and the inflation hedge as rising prices and a falling dollar lead to demand for gold. Either way, if inflation moves higher, so will gold and, subsequently, silver.
- **Commodities:** If we experience reflation, prices on raw materials will increase. This includes not only precious metals, but also industrial metals, agriculture, and energy. Agriculture and industrial metals (such as copper and aluminum) at this point in time are more attractive than energy (oil and natural gas).

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- **International Investments:** If the Fed does QE2, that will drive Treasury prices higher and the dollar lower because the Fed will essentially take bonds out of the market (they bought them) and place up to \$1 trillion in cash in the market in their place. This means a greater supply of dollars, which causes their value to decrease. Thus, our currency devalues. If the dollar weakens, due to the Fed flooding the market with bucks, other currencies will appreciate and create an environment where international stocks and bonds look pretty good relative to domestic names. We like Emerging Markets more than Developed International/Large Foreign, because Emerging Market currencies may appreciate more and potentially benefit from their sizeable commodity-based output.
- **Emerging Market Bonds (in local currency terms):** In addition to having higher yields than traditional fixed income investments, appreciating currencies and strong fiscal balance sheets (low national debt) are likely to result in continued appreciation of emerging market bonds. In addition, emerging market countries face the exact opposite issue than that of the developed world, they face rapidly rising inflation due to strong economic growth rates.
- **Materials, Industrial, and Energy Sectors:** While stocks in general would benefit if the Fed is successful in achieving strong economic growth, the clear winners are those sectors of the market that benefit most closely from rising inflation. Therefore, sectors such as Materials and Energy that mine, drill, develop, and sell commodity-related products, as well as industrial companies that supply machinery to find and mine commodities, should benefit most as inflation inches higher.
- **Treasury Inflation-Protected Securities (TIPS):** If the Fed is successful in achieving higher inflation levels, TIPS should work well for two reasons. First, if the Fed does enact a second round of quantitative easing, Treasuries and TIPS will most likely be what the central bank buys, which would create upward pressure on prices. Secondly, the principal value of TIPS increases with inflation.
- **Real Estate:** Rising prices (smoke) comes from greater economic growth (fire), which would fuel employment gains and boost housing demand. Given improving fundamentals and currency appreciation potential, we prefer international real estate opportunities relative to domestic.
- **High-Yield Bonds:** Yields on Treasuries are already near all-time lows and could move lower with any Fed intervention, so yield seeking investors may look to High-Yield Bonds to provide greater yield characteristics. In addition, any successful reigniting of growth will also benefit the more economically sensitive high-yield bond sector.

## Losers in the Move to Reflation

While the winners in the move to reflation are numerous, the losers number but two.

- **The Dollar:** The Fed essentially announced a war on the dollar in their FOMC statement. If the Treasury enacts its second round of quantitative

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easing, its buying of bonds and selling of dollars would flood the market with greenbacks. The result is an increase in the supply of dollars, which leads to dollar devaluation. In addition, despite being near its lowest levels of the year, the dollar has been somewhat propped up lately by cautious investors buying dollars in fear of a double-dip recession and as a result of the struggles that continue to plague Europe. However, if growth reaccelerates in the United States, the “fear trade” will unwind and the demand for dollars will wane.

- **Banks:** The Financials sector, primarily banks, are the biggest losers here. If the Fed does announce QE2 (or even if the market thinks it will), Treasuries will continue to rally, sending intermediate-term Treasury yields lower. That means the yield curve flattens as the difference between the stable returns of short-term Treasuries and the lower yields of intermediate-term Treasuries decline. The result is that the spread, which is the difference between intermediate- and short-term Treasuries, compresses. This is bad for banks since they rely on wider spreads to maximize profits as they borrow short (low rates), lend at higher rates, and keep the difference as profit. As spreads compress, so do the profits of banks. Since the FOMC announcement, few investments have fared worse than banks and this is likely to continue.

## The Opportunity

While the economic growth car is continuing to inch along slowly, it is apparent that there is a leak in a tire or two. The fact that the Federal Reserve Bank will most likely pull over to the side of the road and provide a short-term economic boost by breaking out their handheld bike pump (quantitative easing) means the U.S. economy will likely avoid both deflation and a double-dip recession. Moreover, several great investment opportunities emerge that could play important roles in investor portfolios as the reflation trade dominates the latter part of the year. We continue to believe that the stock market will end the year at higher levels than where we sit today and that market leadership will come from those vehicles that most benefit from re-inflated tires. That said, leaky tires hold air for only short distances, so continue to have an eye towards cautious portfolio driving and be sure to keep that bike pump handy. We just might need to use it again.

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The economic forecasts set forth in this presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Past performance is no guarantee of future results.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Risks inherent to investments in stocks include the fluctuation of dividends, loss of principal, and potential illiquidity of the investment in a falling market.

Investing in specialty markets and sectors carry additional risks such as economic, political, or regulatory developments that may affect many or all issuers in that sector.

Investing in real estate/REITs involves special risks such as potential illiquidity and may not be suitable for all investors. There is no assurance that the investment objectives of this program will be attained.

High-Yield/Junk Bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

Mortgage Backed Securities are subject to credit risk, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Precious metal investing is subject to substantial fluctuation and the potential for loss.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index, while providing a real rate of return guaranteed by the U.S. Government.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

**Materials:** Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products, and related packaging products, metals, minerals and mining companies, including producers of steel.

**Industrials:** Companies whose businesses: manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment, and industrial machinery; provide commercial services and supplies, including printing, employment, environmental, and office services; provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

**Energy:** Companies whose businesses are dominated by either of the following activities: the construction or provision of oil rigs, drilling equipment, and other energy-related service and equipment, including seismic data collection; the exploration, production, marketing, refining, and/or transportation of oil and gas products, coal, and consumable fuels.

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