Great Expectations

For many months now, Miracle Mile Advisors have been watching inflation pressures mount as rising fuel costs feed through the economy and into the budgets of consumers through direct (gasoline) and indirect (cost of inputs and transportation) means. On top of the oil price surge, the increasingly strained global supply/demand balance for agricultural commodities has sent food prices soaring, impacting consumers in a very basic way. These persistent trends have strengthened our belief that inflation is emerging as the most pressing issue facing the economy, as we have argued in our recent research:

> *"The bottom line is that most American consumers are feeling a hit from rising food and energy prices, and any measure of inflation that does not take this into account is misleading."* – What's the Story with Inflation?, *Nov. 30, 2008*

> *"Developing countries are driving world demand growth for oil, making it possible that elevated oil prices are here to stay for the foreseeable future."* – The Year Ahead: 2008, *Jan. 15, 2008*

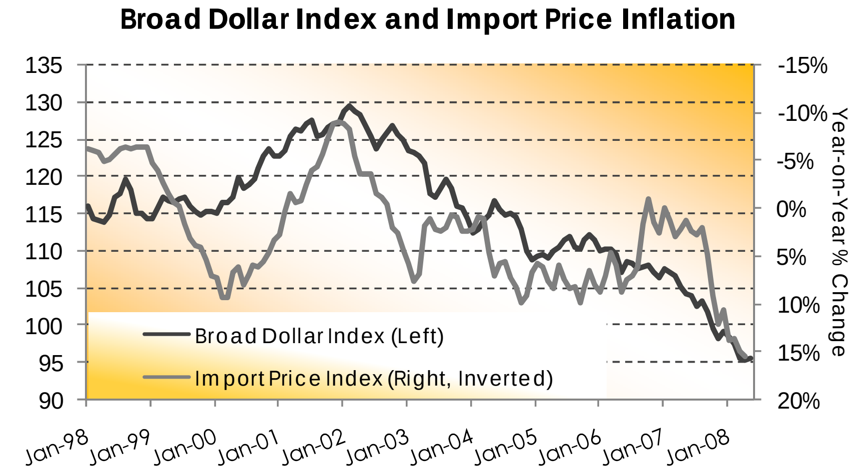
> *"Continued dollar weakness could imply imported price inflation going forward, and in combination with the accommodative monetary policy stance currently in place we maintain our view that inflation will emerge as a major concern by the end of the year."* – Dollars and Sense, *May 16, 2008*

Until very recently, most market observers, including the Federal Reserve, remained more focused on stimulating economic growth than dousing the sparks of inflation. While we never doubted that the Fed's series of interest rate declines were necessary to stave off a severe credit crisis following the mortgage melt down, we did wonder, *how much is enough?* Now after injecting 325 basis points of monetary stimulus over the past 9 months, the rhetoric from Fed officials has veered quickly and sharply toward a stance that is hawkish on inflation and supportive of the dollar.

"Rhetoric Is the Art of Ruling the Minds of Men" – Plato

During the tenure of Alan Greenspan, deciphering "Fed Speak", and thus the policy inclinations of the Federal Reserve, became a national pastime. The current Fed Chairman, however, has recently been expressing his views in a much more straightforward way. Since early June, Chairman Bernanke and other policy-making committee members have been giving speeches with a marked change in tone. Instead of emphasizing the potential for continued downside weakness in the economy, we have heard almost solely about inflation concerns. Chairman Bernanke has addressed three major points: First, the weak U.S. dollar and its impact on inflation; Second, the increase in inflation expectations; And, third, the inflationary effects of persistently elevated commodity prices.

Although the U.S. Treasury Department is responsible for U.S. currency policy, Bernanke indicated that the Fed has an interest in the dollar remaining a "strong and stable currency," and will formulate policy accordingly. He acknowledged that the weaker dollar has contributed to import price inflation, which we believe is accelerating domestic consumer price inflation. With Americans paying more for gas, food, and formerly-cheap imports from Asia, they are beginning to ratchet up their expectations of future inflation.



Source: Federal Reserve Bank of St. Louis, Bureau of Labor Statistics

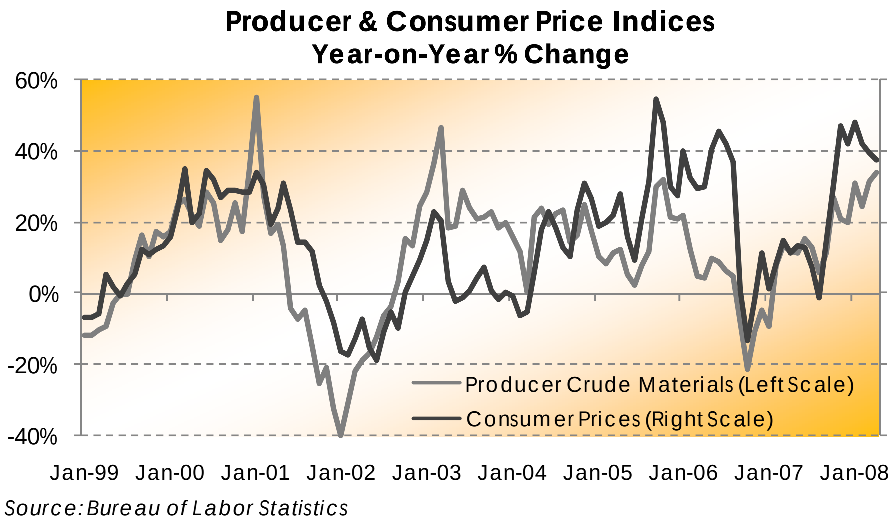
"In the Long Run, We Are All Dead" – John Maynard Keynes

During the past week Chairman Bernanke repeatedly emphasized that the central bank has a responsibility to maintain price stability over the ***medium term***. He says this to distinguish between the current inflation rate, for which little can be done from a policy perspective, and the expected inflation rate 9 to 18 months in the future. This focus on the medium term is why policy makers have historically used "core" measures of inflation, which exclude goods with volatile short-term price movements such as food and energy, as their primary indicators. But now given the persistence in commodity prices, the Fed seems to agree that removing food and energy prices from any inflation analysis is not realistic. Chairman Bernanke commented that supply and demand conditions are the most important factor driving up commodity prices, finally acknowledging that their impact may not be temporary. This hesitance to view commodity price increases as anything beyond short-term fluctuations may (partially) explain why the Fed did not express inflation concerns earlier in the commodity/oil/food price escalation spiral.

"Invest in Inflation. It's the Only Thing Going Up" – Will Rogers

With the Fed zeroing in on inflation expectations, as well as commodity and import price inflation, they are signaling that they will begin taking the necessary measures to combat rising price levels. However, is inflation really contained in expectations, or has it begun to pass through the economy, already accelerating consumer price inflation?

We see a good deal of anecdotal evidence that points to inflation already impacting the U.S. consumer. Today, it appears as though increases in the prices of producer crude materials are feeding through to consumer prices without much of a lag. Producers are feeling the impact from the global squeeze on materials, and are beginning to pass along the pain:



"Dow Chemical said it will boost prices of its products by up to 20%, citing soaring energy prices, a move that may fuel inflation in consumer goods." – The Wall Street Journal , May 29, 2008

"Eastman Kodak Company today announced that it will increase prices on a select range of consumable products across its businesses on a worldwide basis. Prices will increase as much as 20%, depending on product line and geography. The increases are a result of the soaring prices of key raw materials, especially silver and aluminum, as well as the rising cost of petroleum." – Business Wire, May 30, 2008

"Formula for Success: Rise Early, Work Hard, Strike Oil" – Jean Paul Getty

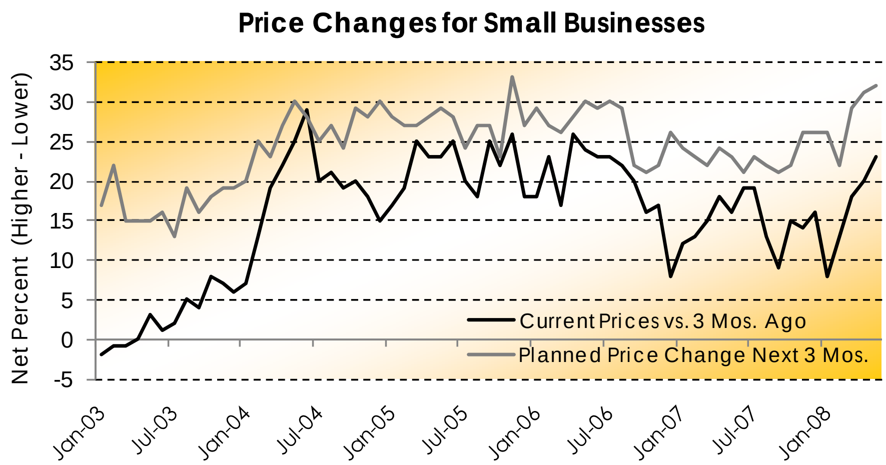
Given this information, the typical American consumer might say, *"I don't buy a camera every day, and I don't even know what Dow Chemical does. Do their price increases have an impact on my daily life?"*

The answer would be, *in more ways than you can imagine*. The impact of skyrocketing oil prices does not stop at the gas tank or even that of the tractor-trailer hauling merchandise across the country. Goods that people use in almost every facet of their lives are built from products derived from oil. This is just a *partial* list of products made with ingredients that Dow Chemical and other chemical companies refine from oil and natural gas:

Plastic bottles (and all things plastic), fertilizers, rubber, polyesters, paper towels, diapers, bath tissues, paper, glue, paint, light bulbs, cushions, mattresses, car seats, carpets, steering wheels, cosmetics, deodorants, detergents, hand lotion, linoleum, panty hose, perfume, shampoo, toothpaste, candles, golf balls, contact lenses, computer and television screens, and mobile phones.

Many producers are looking for natural alternatives. Companies like Procter & Gamble and Goodyear are substituting natural oils such as palm oil for petroleum-based ingredients, and natural rubber for synthetic, however now the prices of the alternatives are rising. If these costs continue to rise, companies can only absorb so much before their profit margins shrink and they are forced to raise end-consumer prices.

Small businesses are hit even harder by higher input prices, and are expressing their intentions to pass through the costs. According to the June NFIB Small Business Survey, the percentage of small business owners who cite inflation as their number one problem is up 3 points to 17%, the highest reading since 1982.



Source: NFIB Small Business Economic Trends, June 2008

"In the Fight between You and the World, Back the World" – Frank Zappa

In Asia, there is clear evidence that inflation is taking hold. In Japan, the producer price index for May gained 4.7% year over year, the fastest pace in 27 years. Producer prices in South Korea hit a 9-year high in May, rising 11.6%. And just last week governments in Malaysia and India relaxed fuel price controls, a move which follows the lead of Indonesia, Taiwan, Pakistan and Sri Lanka, which will boost the cost of fuel for consumers.

Across the developed world, however, there is a sea change occurring in central bankers' inflation thinking. Just as the U.S. currency began to gain some ground on Chairman Bernanke's pro-dollar remarks, the European Central Bank's Chairman Jean-Claude Trichet declared the imminent possibility of raising interest rates due to elevated commodity prices, and promptly sent the dollar south. Since the ECB and Bank of England have inflation control as their sole mandate, they have no choice but to keep short-term rates high to stave off inflation. The U.S. has a vested interest in keeping U.S. rates somewhat in line with those in Europe to avoid continued downward pressure on the dollar, which would make the Fed's inflation-fighting job even more difficult. As we discussed in our "Dollars and Sense" research piece last month, a weak dollar makes imports more expensive and puts upward pressure on commodities such as oil and metals, which are priced in U.S. dollars. Even in Canada, where annual consumer price inflation has remained well below its 2% target, the central bank declined to cut rates for the first time in more than 6 months, citing concerns over rising prices.

"Always Look on the Bright Side of Life" – from Monty Python's Life of Brian

The good news is that Fed is looking in the right direction. Despite the dollar's downward blip after the ECB's hawkish comments, the U.S. currency has since regained some strength. U.S. Treasury rates are also rising, with the 2-year Treasury now yielding 2.83%, up from 2.51% at the beginning of June, and the 10-year is yielding 4.10%, up from 3.98%. Higher rates will prove more attractive to foreign investment, thereby helping to support the dollar.

Chairman Bernanke believes that over the past month or so the risk of a “substantial downturn” in the economy has diminished. Most recent economic reports have surprised on the upside: GDP growth was revised upward for Q1 2008, signaling that the U.S. is not officially in a recession; manufacturing shrank less than expected in May; and retail sales numbers also came in stronger than expected. Even the May employment report, which sent the U.S. equity markets into a tumble last Friday, was not as bad as it appeared on the surface. The increase in the unemployment rate was largely due to the high number of new entrants to the workforce, particularly unemployed teenagers looking for summer jobs. In fact, the rate for unemployed adults is still below 5%. Areas of weak employment are concentrated in the areas of construction and manufacturing, while workers in technology, law, and engineering remain in high demand with unemployment rates of less than 2%. College graduates overall have an unemployment rate of about 2.2%. Given this recent economic and employment data, we believe it is unlikely that the U.S. will devolve into a 1970s style wage-price spiral of stagflation.

As evidenced by Friday’s reaction to the employment report, the equity markets now seem to be moving more in synch with consumer related issues than mortgage/credit news. We see this as a positive development, since it seems that the world’s major central banks are ready and willing to fight inflation to support their domestic economies. While we believe that at least some portion of the recent run up in oil is due to speculative investors, our view is that agricultural commodities are firmly supported by world demand and a shortage of supply. For our Real Assets allocations, we are putting new money to work in the agricultural area of the commodities markets. We have expanded our U.S. equities position to encompass Canada, rebranding it a North American allocation. Diversifying into Canada provides exposure to a country with a still-low inflation rate, a strong currency, and a sizable Financials sector which for the most part did not participate in the aggressive lending practices that have crippled the U.S. banking sector.

June 11, 2008

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