

Policy and Inflation



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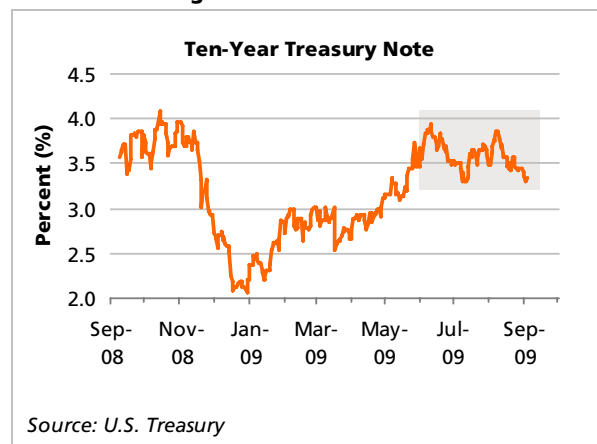
Bond markets have been trading within well-established ranges for some time. Interest rates are below June peaks, though longer rates are much higher than they were at year end. All categories of risky assets have done well in recent months and have thus far held on to their gains.

Markets have now priced in some degree of economic recovery, and GDP is likely to be positive in the second half of this year. Even so, increases in interest rates are just as likely to be some way off. There are several reasons. First, whatever growth the U.S. economy musters will be below its capacity level, resulting in the continued shedding of jobs and higher unemployment through 2010. The Fed has no history of raising the federal funds target rate coming out of a recession until the unemployment rate has peaked. We expect the current Fed will also wait for solid job gains before tightening monetary policy. In other words, a very high unemployment rate is a strong argument against the likelihood of an increase in interest rates.

Expectations of limited inflationary pressures also testify for an extended period of interest rates at moderate levels. The economy's substantial output gap indicates we are underutilizing our resources; a surplus of most of the means of production (labor, operating capacity, etc.) means limited pricing power for these economic inputs. Inflationary price spirals are a process and not an event, so the situation will not reverse itself quickly. Recent anemic inflation data and the apparent ease with which the Treasury has been able to issue a huge supply of new securities appears to affirm this view. We also see limited inflationary pressures in the Treasury Inflation-Protected Securities (TIPS) market, where there is only a 1.1% difference between the straight five-year Treasury and the five-year TIPS rates.

Given the unprecedented U.S. budget gap and the substantial stimulation provided by monetary accommodation, the eventual exit strategies are disconcerting to many market participants. While the Fed has taken pains to convince the market that it will unwind its accommodative policies at an appropriate time and thus not provoke inflation, many investors are skeptical. More so, they are concerned that the markets have not priced in a

Bond Yields Range-Bound Since June Peak



resultant inflationary cycle and associated currency debasement. While some may choose to begin to hedge these risks, it's likely these events are just too far off in the future.

That said, "policy errors" (of many types) are a very real concern. When the government starts to reverse the varied accommodation policies (especially the quantitative easing, the fiscal stimulus and the term financing on the Fed balance sheet) the outlook for many asset classes will be impacted. Of more immediate concern, however, are the policy changes at the state level, in particular, the substantial state tax increases we are witnessing. Tax receipts have dropped significantly; raising taxes, as opposed to spending less, is likely to become an even more widespread solution. This will slow the rate of growth in disposable income and as a result stretch out — perhaps for years — the timeline for household balance sheet repair, so needed after the decline in both housing prices and retirement assets.

Yes, there will be second-half growth from inventory rebuilding and the flow of stimulus dollars, but the rebound's sustainability is jeopardized when consumers are still challenged by job losses, a lack of wage gains and trampled asset values. Given an urge to save and a higher tax burden, they won't be bidding up home prices or revisiting historical spending patterns any time soon. We believe an environment that will not nurture inflationary forces is one that will support owning fixed income assets.

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