IdahoTrust

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WealthManagement

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Market Insights

A periodic newsletter from Idaho Trust

Inflation is the rate at which prices of goods are rising and thus lowering the purchasing power of consumers' monies; this affects everything from food, clothing, transportation, doctors, medicine, and other items required for day-to-day living. In the aftermath of World War I, John Maynard Keynes stated "There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency." Mr. Keynes was referring to inflation, which has been on the minds of many investors and in the news recently. This month's market insight provides an update on inflation and the market's expectations.

An Introduction to Inflation

An example of inflation is: an item that costs $ 1.00 today at a rate of inflation of 2% would cost approximately $ 1.02 next year. A decline in inflation is referred to as deflation.

In 1913, the United States Congress established the Federal Reserve as an independent agency in response to a series of financial panics. Today, the Federal Reserve operates under the dual mandate to maximize employment and to maintain stable prices. The Federal Reserve does this largely through its monetary policy.

In order to fulfill its mandate to maintain stable prices, the Federal Reserve targets a benign inflation rate. A low manageable level of inflation allows the Federal Reserve to keep prices steady and avoid deflation, which hasn't been felt in force in the US since the 1930's.

Deflation is not simply prices of goods becoming less expensive, which sounds pretty good, but widespread declines in demand that cut deeply into corporate profits and feeds back into the economy in the form of layoffs, less hiring, lower wages and pay-cuts which fuels even more deflation. Deflation can and does occur in the most advanced modern economies. The best recent example is Japan. Until recently Japan was the second largest economy in the world. It has been struggling with its own deflationary spiral since 1995.

Measuring Inflation

Inflation is measured in two ways: headline inflation and core inflation. Headline inflation, measured by the Consumer Price Index (CPI), is what consumers experience. Core inflation, measured by Core Personal Consumption Expenditures (Core PCE), measures the rate of price change excluding food and energy prices. These are excluded because they tend to be the most volatile components of inflation. Core PCE is the preferred inflation measure used by the Federal Reserve.

The CPI is composed of the following categories of items: food and beverage, housing, apparel, transportation, medical care, recreation, education, communication and other goods and services. This information is gathered and released monthly by the Bureau of Labor Statistics using existing census data and surveys of select urban consumers.

Current Inflation

To pull the economy out of the recession the Federal Reserve established an accommodative monetary policy and the Government instituted an expansionary fiscal policy, which both typically fuel growth and inflation. This has many market participants worried that inflation may once again re-emerge. Fortunately, the country has not seen headline inflation above mid 6% since the 70’s and early 80’s.

Currently, inflation is still below its historic averages. The latest reported CPI figure of 3.6% is below its 50 year average of 4.1%. Similarly, the latest reported Core PCE figure of 1.3% is below its 50 year history of 3.6%.

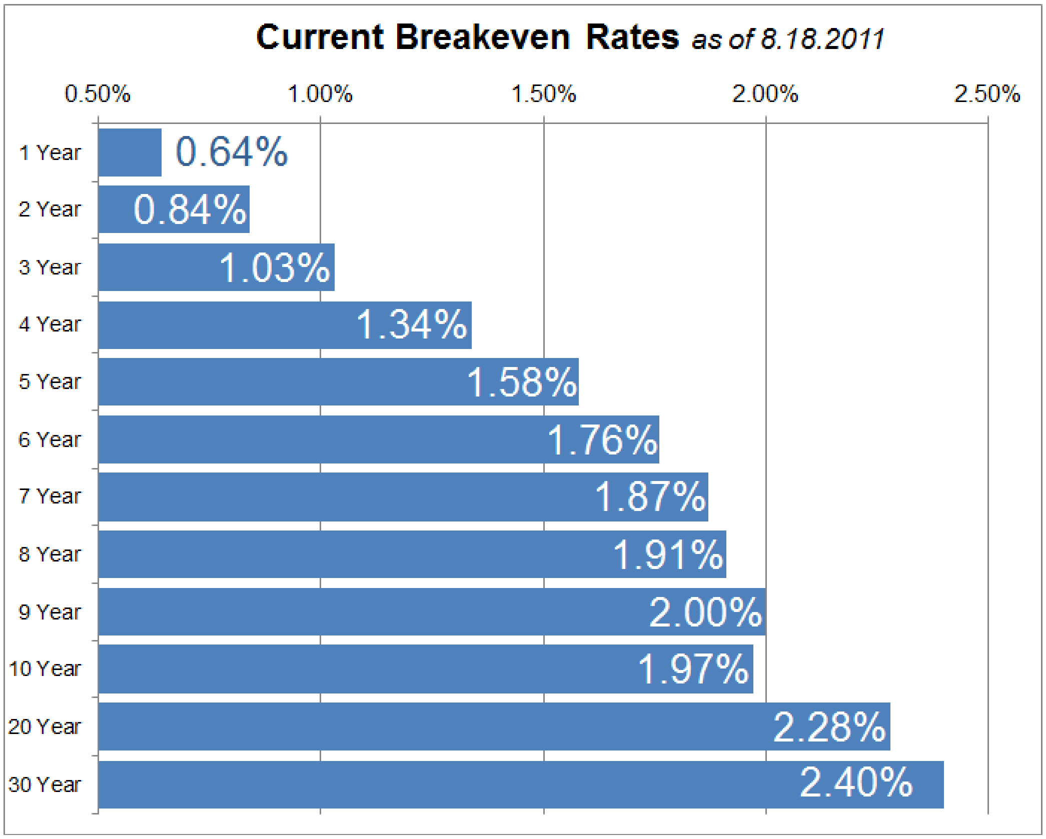
Market’s Forecast

Given that inflation is currently below historic averages, we know that it is not at alarming levels. Considering both the Federal Reserve’s and Government’s policies many are worried that it soon will be. Various measures were taken by the Federal Reserve to breathe life into the ailing economic recovery. The Federal Reserve began lowering its Federal Funds rate, its primary policy tool of lowering interest rates, in late 2007 from 5.25% to 0.25% at the end of 2008. Additional measures were taken most notably, the Federal Reserve engaged in two separate rounds of what is known as “Quantitative Easing.” These have been referred to as QE1 and QE2. Outside of the Federal Reserve, unprecedented stimulus programs have also been implemented by the Government. Given all of these measures it is natural to expect an increase in inflation.

Idaho Trust Bank offers holistic wealth management services featuring its LifeNeeds™ investing process. Idaho Trust’s LifeNeeds™ investment process utilizes proven strategies and techniques delivered by a highly trained staff of wealth management professionals.

LifeNeeds™ wealth management accounts feature optimized asset allocations, robust security screening and Idaho Trust’s unique Tactic-Logic™ investment process. All of which are tailored to our client’s unique financial needs, insuring LifeNeeds’™ clients the best possible expected return according to their risk tolerances.

However, the market is not expecting an abnormal increase in inflation anytime soon. Current break-even rates, the differences in Treasury yields versus Treasury Inflation-Protected Securities' yields (TIPS), are showing that the market is expecting only modest increases in inflation overtime (shown below). Given that core inflation is still below the Federal Reserve's target rate of 1.5% to 2.0% and its wealth of experience managing inflation, the market is not concerned with an unexpected or rapid rise in inflation. Rather, markets are positioned for a slow and methodical increase in inflation to within target levels.



Recommendations

Investors have viable options available to them to protect the purchasing power of their investments during periods of inflation. There are several asset classes that have provided superior returns in inflationary environments. Treasury Inflation-Protected securities, Real Estate and Commodities are all examples of asset classes that have performed well during periods of inflation. The US Dollar is another victim of inflation and would lose value if inflation were to rise. Allocations to non-US Dollar denominated securities can help hedge against domestic currency risk.

Conclusion

In order for sustained high levels of inflation to take root the conditions must be right. The economy is still not operating at its full capacity, incomes are largely stagnant and credit is limited. The high unemployment rate and the weak housing market constitute a poor environment for sustained inflation to take hold. Until the mentioned conditions change, inflation is projected to stay within manageable levels.

CPI

Current	3.6%
Hist. Avg.	4.1%

Core PCE

Current	1.3%
Hist. Avg.	3.6%

Barclays Treasury Inflation Notes Index

3 Month	5.07%
Year-to-Date	9.95%
1 Year	11.79%
3 Year	6.82%
5 Year	7.38%

Global CPI

Developed	2.8%
Emerging	6.5%
America's	4.3%
Asia/Pacific	3.9%
Europe/Africa	3.6%

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