

## **MARKET COMMENTARY**

April 2, 2010





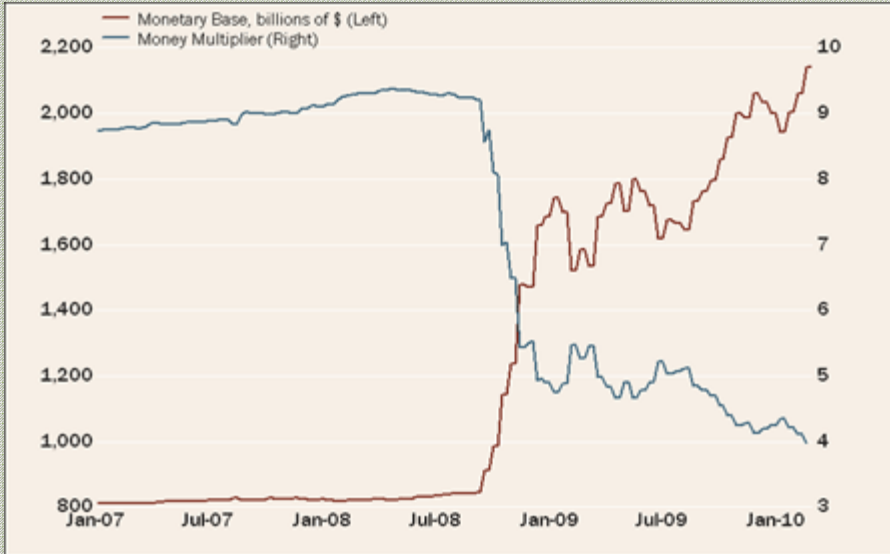
***So much data – what it all means.***

Inflation is a main concern of many investors and economists, but is it really the monster in the closet that many people fear? Massive government stimulus and rates at historic lows could lead many to believe that inflation is a given. We agree that the risks are there and that we will move into a more inflationary environment, especially considering that we are currently in a deflationary period. However, we don't think it will be a period of uncontrollable inflation. Headline CPI has recently come in at a 2.6% year over year rate, but core CPI has actually dropped for the first time in 28 years. These CPI numbers and a high unemployment rate of 9.7% will keep the Fed from making any headline changes to the Federal Funds Rate.

The Fed has begun to make subtle changes including an increase in the discount rate, the rate at which commercial banks can borrow emergency cash from the central bank, and an announcement that they will begin to slow their purchase of securities that have helped to prop up the bond market, effectively keeping yields at incredibly low levels.

To say that we are in an abnormal time of economic policy could be the understatement of a lifetime. Never in history has the Federal Reserve or Treasury pumped so much liquidity into the U.S. economy and created such an extraordinary opportunity for economic expansion. The monetary base has increased from \$800 billion in July 2008 to over \$2.1 trillion 18 months later.

Although, the monetary base has grown dramatically, the “money multiplier” has fallen off a cliff. Money multiplier refers to the amount a bank can lend, which typically is about 9 times the amount of its deposits. The Fed can grow the monetary base and pump liquidity into the banking system, but it can only be multiplied IF banks are lending. The funds are not required to be lent and without lending, banks will build excess reserves as is the current situation. To truly spur economic growth businesses and individuals need to start asking for loans and banks need to provide them.



Source: FactSet, Federal Reserve, as of February 26, 2010

One important indicator that could be very telling is the current state of the yield curve. We are in a time of record positive spreads between short and long term rates, creating a very “steep” yield curve. This translates into common speak that the cost of borrowing is extremely cheap and the return on lending is much higher, a healthy environment for the economy.

The two other most recent times in history when spreads were even close to these levels were October 2003 and October 1992. Both of these periods were at the beginning of extended economic recoveries, something a steep yield curve tends to forecast. Taking these spreads into consideration, the bond market is more convinced than economists that the economic recovery has some legs.

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