

# QUARTERLY REPORT

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## RINGING IN A NEW START

We've rung out the old, a fairly prosperous 2010, and are encouraged by prospects for the New Year. It is a year and a half since the end of the Great Recession; the US economy continues to rebound and the stock market has nearly erased all of its losses since the meltdown on Wall Street (epitomized by the collapse of the iconic investment bank, Lehman Brothers in the fall of 2008). Corporate earnings have been on the rise for the past year and are projected to rise further in 2011.

Whereas much of corporate earnings in 2010 arose from painful cuts in capital expenditures and labor, we are heartened that increased earnings in 2011 will most likely emanate from increased revenues and productivity.

We are hopeful that the stubborn "jobless recovery" will lose its handdog name as new hires gradually erode the 9.4% national unemployment rate. There is reason to think that Washington will operate from the middle, as reflected by the recent "tax compromise", which removed great uncertainty for investors and management alike.

The Federal Reserve continues its Herculean challenge to encourage optimal economic growth while maintaining price stability. This dual mandate is a tricky proposition for the Fed and is the source of great criticism

from all quarters. On the one hand, many want the Fed to keep interest rates low to encourage lending and job creation. On the other hand, "bond vigilantes" seek higher interest rates in order to stave off increased inflationary expectations.

The first part of our newsletter begins with a brief review of the different types of inflation. The next sections review market and economic developments in the fourth quarter of 2010; and finally, we offer our projections for the first quarter and balance of 2011, in terms of both challenges and opportunities.

Cordially,  
Kathy Wimmer, CFA, CIC  
President



## KEY FACTS FOR 2011

- *Annual gift exclusion*  
\$13,000
- *Estate, gift and generation-skipping tax exemption*  
\$5 million
- *Highest marginal estate tax rate* 35%
- *IRA contribution limits*  
\$5,000, plus another \$1,000 for those over fifty
- *SIMPLE IRA and 401(k) contribution limits*  
\$11,500, plus another \$2,500 for those over fifty
- *401(k) contribution limits*  
\$16,500, plus another \$5,500 for those over fifty
- *SEP IRA contribution limits*  
25% of compensation, max of \$49,000
- *Top Federal tax rate is 35% on income over \$379,150*

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## INFLATION

*“I’ve changed my hairstyle so many times now, I don’t know what I look like!”* David Byrne, *Life in Wartime*

According to *Investopedia*, inflation refers to “The rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling.” The myriad styles of inflation, however, make a confusing collection. There is headline inflation, core inflation, wage inflation, cost-push inflation, hyperinflation, CPI, PPI and more; economists do their very best to keep our heads turning.

Headline inflation is the most useful term as it includes virtually all sources of inflation via the Consumer Price Index (CPI), which is based on a fixed basket of goods. Core inflation also utilizes the CPI but notably excludes the cost of food and fuel, which are deemed too “volatile” to be measured on a monthly basis by the Bureau of Statistics.

Wage or demand-pull inflation occurs when the demand for goods or services exceeds the supply of the same. Cost-push inflation occurs when the unit costs of goods or services increase and lead to a quick rise in the price of finished goods. The Producer Price Index (PPI) measures the average change over time in wholesale prices.

The Federal Reserve Bank of the United States has a “dual mandate”: first, to promote maximum

employment; and, second, price stability. This dual mandate is inherently contradictory. The Fed keeps interest rates low in order to promote lending and increased production but raises interest rates when the economy is believed to be overheating with increased inflationary expectations. There is the perpetual concern that the Fed cannot “fine tune” the economy, which explains repetitive booms and busts in specific asset sectors such as the internet, housing and commodities!

There is growing concern that the Federal Reserve’s current Zero Interest Rate Policy (ZIRP) is an intentional move to accelerate inflation in the economy. Why would a central bank want to increase inflation? The answer may lie in the record fiscal deficits at the Federal, State and local levels. By increasing inflation, public debts can be paid back in depreciated dollars. Another rationale for ZIRP is to lower the value of the US dollar, which makes our goods and services more price competitive than those of our overseas trade partners. In fact, our trade partners are complaining that the Fed’s ZIRP is actually exporting inflation by increasing the worldwide costs of commodities like oil, copper and corn which are all priced in dollars. Developing countries like China, India and Brazil have all recently raised interest rates in a move to counter double-digit inflation in food costs.

Interestingly, it appears that the Fed has sought inflation in the stock market. In a recent speech, Federal Reserve Chairman Ben Bernanke stated that “Our policies have contributed to a stronger stock market.” There is a “wealth effect” whereby investors feel more confident and more likely to spend when the prices of stocks (or homes) are rising. The Fed’s easy money policies encourage investors to flee negligible yields on bonds and go out on the risk curve and buy equities, commodities or longer dated bonds in order to earn a reasonable return. The respected economist, David Rosenberg, bemusedly thinks that the Fed has added “higher equity valuation” to its traditional “dual mandate”. By driving up asset values or prices, the Federal Reserve is on an inflationary course.

As investment advisors, we find inflation in its various presentations to be very important to monitor and understand. Inflation is pernicious if left unchecked, especially to individuals reliant on fixed incomes. John Maynard Keynes had a sober view on inflation: “The best way to destroy the capitalist system is to debauch the currency. By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.” We will continue to discuss the fiscal and monetary implications of Congressional and Federal Reserve policies on inflation in the sections to follow.

## FOURTH QUARTER 2010

The initial fourth quarter Gross Domestic Product growth rate was reported by the Bureau of Statistics at a 3.4% annual rate compared to the 2.6% rate in the third quarter. Furthermore, the economy has doubled its growth rate since the first quarter and the trajectory remains upward! This is very good news compared to gloomy forecasts of a “New Normal” as coined by the *“Masters of the Universe”*, Bill Gross and Mohammed El-Erian, at Pimco. The “New Normal” condemns developed countries to years of slow growth and high unemployment. The “New Normal” has made for great press but the prognostication is most likely wrong, and belies economists’ reputation for practicing the “dismal science”. This is not to say that there aren’t terrific challenges facing federal, state and local finances. America’s corporations, the true drivers of the economy, however, are in tremendous financial health and are sitting on large hoards of cash which can be used to retool the capital stock, bring on new workers, increase dividends or launch buybacks of equity!

Headline inflation or the Consumer Price Index (CPI), which includes food and energy, is projected to climb 2.2% on a year-over-year basis for 2011. The core CPI, which is favored as a policy tool, and excludes volatile food and energy, rose 1.2% on a year-over-year basis in 2010. This is well below the Federal Reserve’s unofficial target rate of 2.0% inflation. Chairman Ben Bernanke of the Federal Reserve has cited the low core infla-

tion rate to justify keeping interest rates low and as a rationale to expand the Fed’s quantitative easing (QE) programs. The reasoning goes that with high unemployment and low factory utilization, there is little inflationary impact resulting from loose monetary policy, e.g., the opening of the printing presses by the Federal Reserve.

The broad-based S&P 500 index rose nearly 10% in the fourth quarter and accounted for most of the year’s gains (up 12.8% on an annual basis). With the uncertainty of the mid-term elections behind us, investor confidence surged in the fourth quarter as the US consumer increased spending at a 4.1% annual rate. Not surprisingly, the personal saving rate dropped in the fourth quarter from a stingy 5.9% rate in the third quarter to a 5.4% rate. The drop in the savings rate can also be attributed to higher food and energy costs, but still represents a true effort by the American consumer to improve his balance sheet.

Housing remained in the mire during the fourth quarter as the Case-Shiller Index of home prices in 20 Metropolitan Statistical Areas (MSAs) registered a 1.9% decline from their November 2009 levels. Nineteen of the twenty MSAs declined in November with only San Diego showing a 0.1% rise. New home sales did gain some traction in the fourth quarter, but most likely reflected tax credits for first-time homebuyers in California. Despite this nominal improvement, we are not ready to call a bottom in the housing market yet!

Commodities did well in the fourth

quarter as oil rose to a two-year high in December, before finishing the year at \$91.38 a barrel, up from \$79.95 a barrel at the end of the third quarter. Gold, which continues to serve as a strong alternative to weak currencies, rose from \$1250 per ounce at the end of the third quarter to \$1421 an ounce at year-end. Likewise, silver, palladium, corn and wheat all registered strong gains in the fourth quarter as investors steered to owning “stuff” rather than simply holding sovereign paper. Natural gas, which has lagged other commodities this past year, rose to \$4.39 per mcf at year end, up nicely from \$3.81 per mcf at the end of the third quarter.

Bonds, which have been perceived as “safe havens” by most retail investors compared to “riskier” equities, saw yields rise in the fourth quarter, which inversely made bond prices cheaper. All medium to long-dated Treasuries saw an approximate decline of 3% in the fourth quarter as investors were unconvinced that the Federal Reserve’s November announcement of QE2 (a program whereby the Fed will purchase \$600 million of Treasuries) would have a salutary effect on interest rates. Also, it is not unusual to have a little drop-off in Treasury prices (after a thirty-year Bull Market) now that the Great Recession is over and concerns with profligate government spending remain keen.



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We strive to optimize our clients' financial well being by coordinating investment decisions with other professionals in the fields of taxation and estate planning.

## MOVING FORWARD

The economic recovery from the "Great Recession" is in the early stages and still has room to run. As noted in the previous section the growth rate in Gross Domestic Product, GDP, has doubled in the past year and continues on an upward trajectory. Pessimists maintain that GDP should be growing at a 6% annual rate after bouncing off such a deep recession. We are just happy to see positive growth in the 3.5-4.0% range along with a shrinking unemployment rate. We noted in our last newsletter that "For there to be true economic recovery, the economy needs growing employment, which increases consumer demand and stimulates expanding production."

Clearly the December tax compromise by Congress and the President

has heartened consumers. Once again, however, we see the inflation bugaboo trying to scare off consumers. There is no question that easy monetary policy by the Federal Reserve and profligate spending by Congress have led to commodity inflation, both domestically and abroad. It is the poor who are overwhelmingly affected by food and fuel price inflation, as both commodities take up a much larger percentage of their income than people higher up the economic ladder. Indeed, much of the discontent in Tunisia, Egypt, Jordan, etc. can be attributed to the recent sharp rise in food prices.

We do not foresee any tightening in US monetary policy over the next year, but we expect the Federal Reserve to cease its quantitative easing policy by the end of the second quar-

ter. The Fed is walking a tightrope, not wanting to prematurely cut off its expansionary policies and thus threaten the nascent economic recovery. In the meantime, the old adage "Don't fight the Fed" is in effect. Consequently, we prefer short-dated bonds, as we expect medium and long-term yields will ultimately rise in 2012. In addition, we will maintain a healthy exposure to commodity producers and well-capitalized multinational companies with growing dividends which are benefiting from the world wide economic recovery.



*Disclosure: "Be careful about reading health books, you may die of a misprint." Mark Twain Keep that in mind as you read these articles. We obtain data from sources we believe are reliable but they should not be relied upon for making life-changing decisions.*