

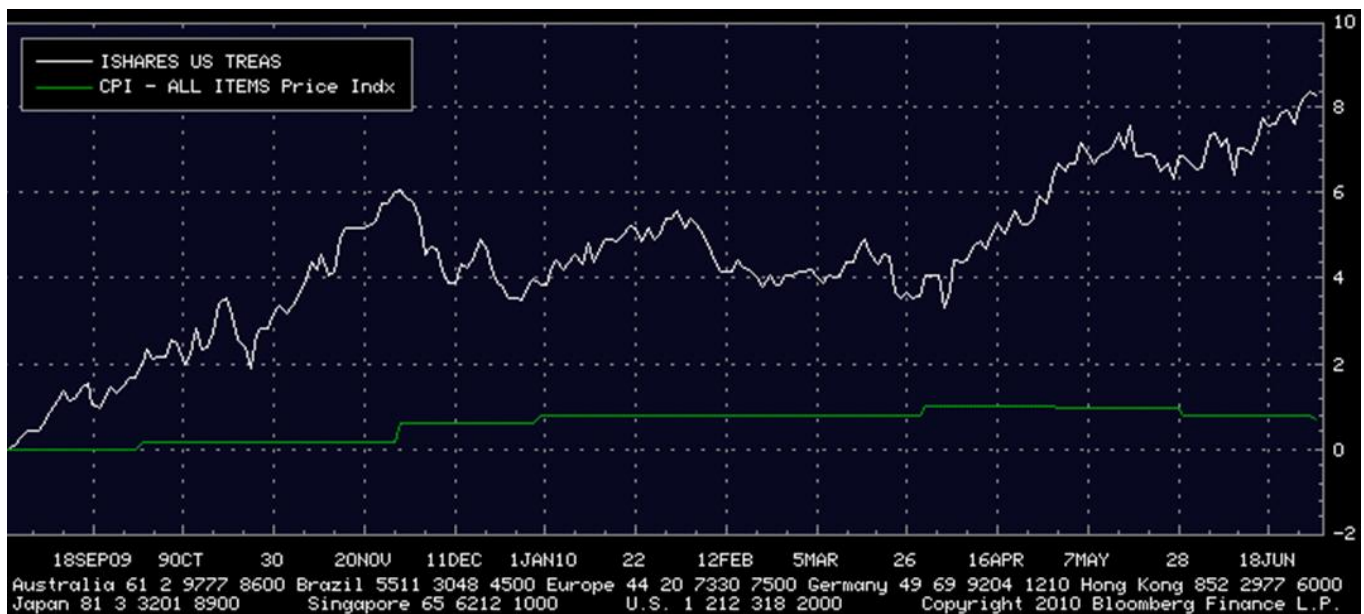
Thought for the Week: Monday, August 2nd, 2010

Inflated Expectations

For much of 2010, one of our main investment themes, **protecting assets against rising interest rates**, has not quite worked as we expected.

Back **in 2009, we began allocating assets to areas we felt were less sensitive to rising interest rates**. We didn't do this because we expected interest rates to rise significantly in the short term, we did it because we felt the 'expectation' of rising interest rates would cause price reductions in asset classes with negative exposure to interest rates and vice versa.

For example, we bought Treasury Inflation Protected Securities (TIPS – the white line below) at a time when Inflation (the green line in the chart below) was fairly flat. **Even though inflation was only up slightly, TIPS rose 6%** on the expectation of rising inflation.



When inflation rose (Nov 2009 to Apr 2010), the value of TIPS flattened. More recently, **TIPS have continued their price appreciation, even though inflation has been falling**. TIPS are supposed to rise with Inflation and fall when Inflation (as measured by the Consumer Price Index – CPI) falls – clearly the vagaries of demand outweighed the government's pricing of TIPS.

This illustrates the old investment adage: **“Buy on Rumor; Sell on Fact”**. **Prices generally move on expectations, not reality**. Investors 'bid-up' TIPS in the expectation, not reality, of rising interest rates.

Although inflation didn't rise as we expected, **many of our investments still benefited from the “Expectation of Rising Inflation”**, as the example of TIPS above. And please remember, we made this type of investment to **Protect against rising Interest rates**, not to chase excess returns.

So, what's next for Interest Rates...?

Inflation and Interest Rates

Historically, **increased Inflation causes rising Interest Rates** at some later stage.

If prices are going up, borrowers must pay lenders **higher interest rates to compensate savers for the fact that prices keep going up**. Ignoring risk considerations, would you keep your money in an account that pays 2% interest if inflation was 5%? This means you are really losing 3% per annum.

Price Increases and Money Supply

Economics 101 states that increasing the supply of anything generally reduces the value of that same thing; assuming demand remains constant. **When the government prints more dollars, the value of the 'dollar in your pocket' therefore falls...**

How So?? If there's more money in circulation chasing the same goods, there's always someone who can bid higher for that specific thing. Prices will therefore rise and **the dollar in your pocket buys less**.

In our portfolios, we decided to protect against rising interest rates (caused by rising Inflation) because we saw the **Government increasing the supply of money in the economy and banking system**. History is littered with examples of governments 'printing money' to stimulate their economy only to experience inflation as a result.

Import Prices Rise

Another example of increased money supply causing price increases involves currencies and imports. **When a country prints more money, it dilutes the value of its currency**, unless economic prospects improve.

How So?? If the market values a company at \$100 million and there are 10 million shares in circulation, the share price will be \$10. If the company issues 10 million new shares, bringing the total to 20 million, the shares will now be devalued to \$5 each. In a similar way, **if a country prints more money, the value of that currency will fall**. If the value of the dollar falls, we will pay more for imports, which will cause domestic prices to rise.

The Story so Far...

The government dramatically increased money supply which many investors knew would be inflationary (raise prices) therefore leading to rising interest rates. Rising interest rates cause bond prices to fall and so we protected our bond holdings against rising interest rates.

Although DIAS portfolios generally benefited from the expectation of inflation, consumer prices have fallen recently; bond prices haven't fallen and interest rates have not risen.

Why haven't Interest Rates Risen?

The short answer to this is: **Inflation has yet to cause price increases because demand continues to fall in a recessive consumer environment.**

Put another way, prices can't rise because consumers would just reduce their purchasing. We are still in the thick of a recession and demand is depressed as a result.

...but what about imports? You said they'd get more expensive? Imports haven't become more expensive because continued economic uncertainty has seen **the dollar appreciate in value even though many U.S. fundamental indicators have deteriorated.**

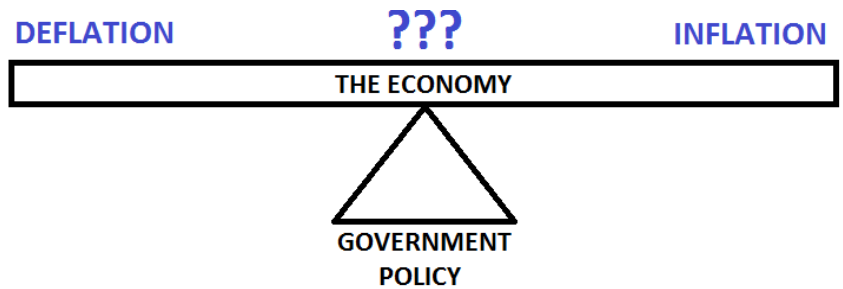
So we are in the clear, we can forget about Inflation and Interest Rates?

Hmmm, nice thought... Most people think inflation means rising prices, but it doesn't - it actually means an expanding money supply which may then lead to rising prices. Inflation is here, it hasn't hit prices yet!

One thing is for sure, the money supply is inflating and last week the Treasury paved the way for a second round of pumping money into the financial system. **Prices are Falling but the Monetary Balloon is Inflating!**

Moreover, the fact that prices can't rise at the moment is **an indication that we are still in a recession, despite all the government stimuli.** Consumers have slowed down spending but the Government is spending for us.

The U.S. has inflation, but the depressed state of the consumer-based economy is forcing prices lower. The U.S. is managing this balancing act partly because **the dollar has experienced a period of strength** and partly because many **other countries keep buying our bonds** as we are considered less risky than most other countries.



Increased demand for our Bonds (government debt) means **the government doesn't have to increase the rate of interest they pay** on this debt to attract more sales.

In addition, there is little political reason for the government to raise interest rates as this will increase the deficit and potentially reduce employment.

So we are in the clear on Interest Rates, if not Inflation?

For now, Yes... If you believe Ben Bernanke, and who wouldn't, interest rates will remain low for a considerable time.

However, inflating the money supply with no consequence cannot continue for too long though – the price will have to be paid.

Deflation – Fear of the Unknown

For now, the Government is more worried about Deflation. **Running a deficit WITH a shrinking economy would be a recipe for economic disaster.** No one quite knows how that might all end (see Thought for the Week - June 7, 2010)

A little deflation is a good thing, but modern Keynesian Economists fear it like the plague. All their models and experiences assume things keep getting bigger and bigger; they see deflation as a price spiral abyss. Indeed, it has been compared to the stalling of an airplane – a death spiral that defies control.



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Our bond portfolios are well positioned for a period of low interest rates; even deflation. As expectations may change at any time, thereby causing prices to change ahead of reality, we maintain a small element of protection against interest rate rises.

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