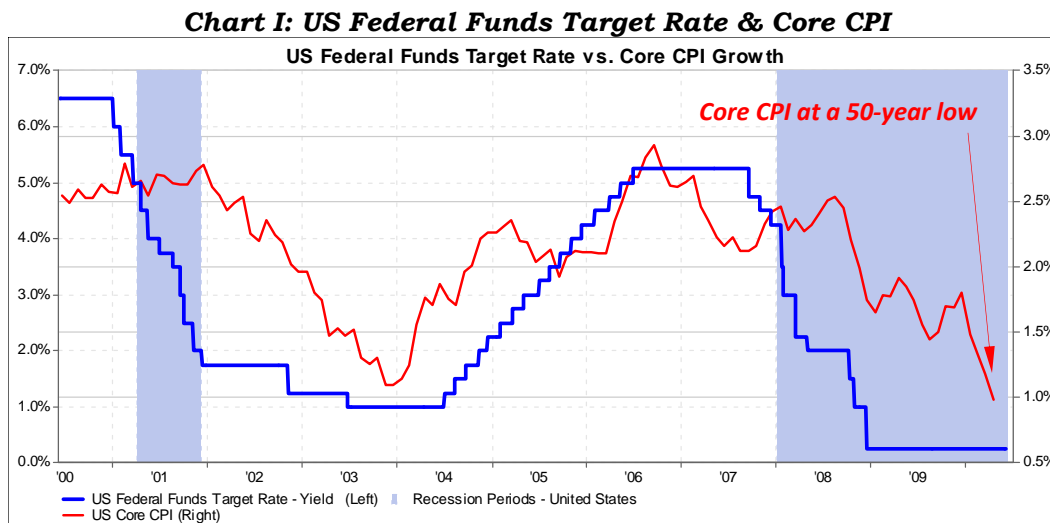


Inflation Concerns and Implications for Your Portfolio

One of the most frequent questions we receive is, “When is inflation coming and how will it affect my portfolio?” Right now we do not believe inflation is an immediate threat due to innocuous Core CPI readings, lofty unemployment and the Fed’s stated intention of keeping rates low. However, we will continue to be conscious of changes to interest rates, as their increase could have ramifications for your investment portfolio, especially on the fixed income side.

Core CPI

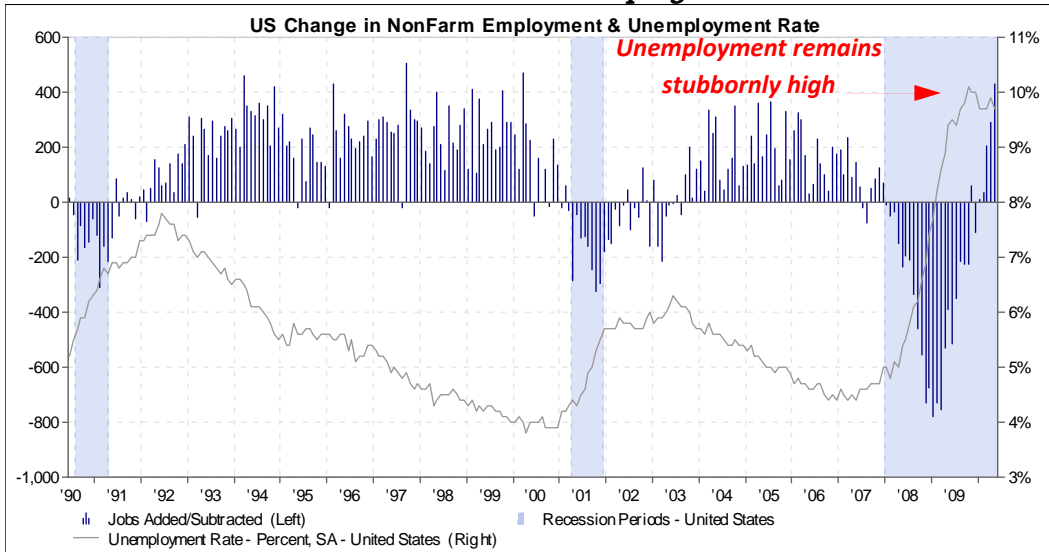
A key gauge of inflation is the Core Consumer Price Index (CPI), and its currently low levels indicate that inflation is in check. The Core CPI represents around 75% of the overall CPI and consists predominately of wages and housing costs, both of which are low: for the last 25 years there has been a secular decline in wages and although housing prices appear to have stabilized, they are far from increasing. In fact, there are questions regarding the ability of the housing market to hold current pricing now that the tax credit has expired. As long as Core CPI stays at its current 50 year low (see Chart I), we do not think inflation will occur.



Source: Rinehart Wealth Management - FactSet Research Systems

Another factor that should keep Core CPI low is that unemployment remains high (see Chart II). Despite some positive signs that unemployment is moving in the right direction, it is not moving quickly and unemployment remains over 9%. Wage inflation, the largest component of the CPI, will not likely occur with such a high unemployment rate.

Chart II: Trends in Employment

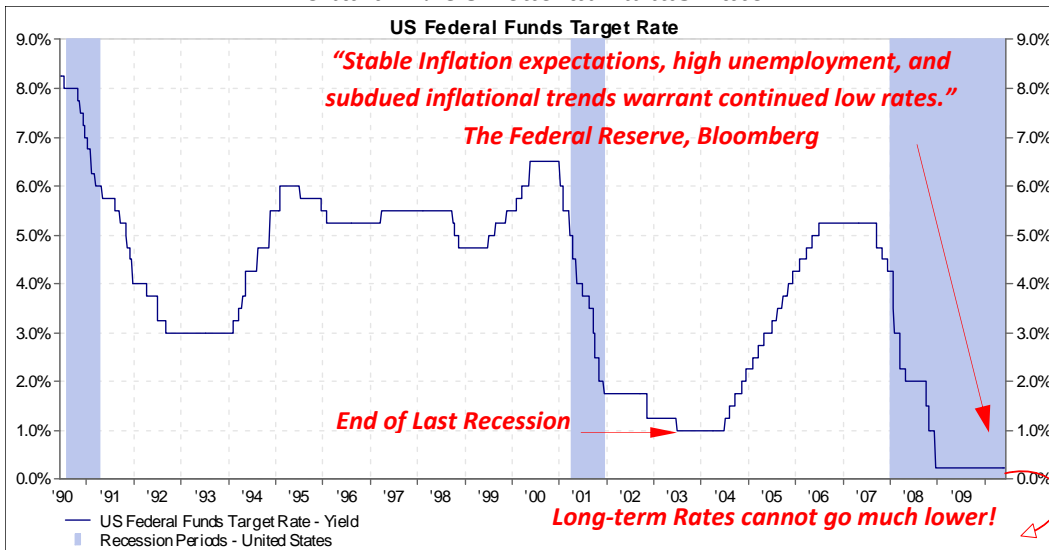


Source: Rinehart Wealth Management - FactSet Research Systems

The Federal Funds Rate

When considering inflation it is useful to monitor the Federal Funds Rate, which is set by the Federal Open Market Committee (FOMC) and is the interest rate at which banks lend balances at the Federal Reserve to other banks/institutions. This rate drives the flow of money and the interest rates earned on cash savings as well as mortgage rates. The Fed will normally keep rates very low to stimulate economic activity in times of recession or economic slowing and when the economy begins to heat up, the Fed will raise rates in an attempt to slow economic activity and control inflation. Currently, the Fed is keeping the rate extremely low (see Chart III), which implies that they are not concerned about inflation and believe policy should remain accommodating to stimulate economic growth.

Chart III: US Federal Funds Rate

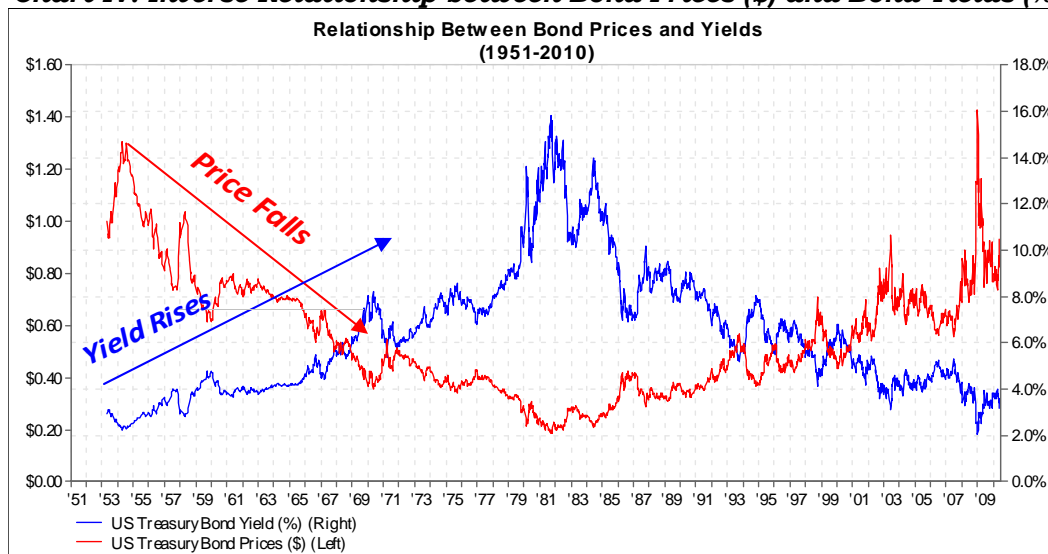


Source: Rinehart Wealth Management - FactSet Research Systems

Given rates are at a low, the logical question is what will happen if the Fed starts to raise rates? As interest rates rise, bond yields go up and bond prices come down (See Chart IV). This scenario will not be good for fixed income portfolios as they will lose value as bond prices fall. In such a tenuous fixed income environment, active portfolio management becomes increasingly important and valuable.

Over the past 20 years inflation has been negligible, serving as a massive tailwind for bonds. If inflation picks up, bonds will not perform well relative to other alternatives; maintaining the real value of your portfolio will be much more important.

Chart IV: Inverse Relationship between Bond Prices (\$) and Bond Yields (%)



Source: Rinehart Wealth Management - FactSet Research Systems

Although we believe inflation is not an immediate issue, we are conscious of the ramifications of the government's spending and we will take action to mitigate the deterioration of client fixed income portfolios if and when the time comes. Potential alternatives to fixed income allocations include increased exposure to high-yielding staples stocks or to hybrids such as utilities, hard assets and alternative investments.

Regards,
Mary Rinehart, CFP®
Daniele Donahoe, CFA

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