# ELF Capital Management, LLC
## *(Endowment Like Fund Management)*

August 4, 2009

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### Will Inflation be Our Next Worry?

For months now, we have been hearing various pundits debate over potential the long-term effects of the Federal Reserve Bank's massive expansion of its balance sheet and how the US Dollar could dramatically fall as a result of too much Government spending. Some investors are making large bets that these events will cause severe inflation down the road. Ever listened to those "Cash For Gold" commercials?

Inflation is defined as a sustained rise in overall price levels. As an economy grows, businesses and consumers typically spend more money on goods and services. In the growth stage of an economic cycle, demand typically outstrips supply and producers can raise their prices. As a result, the rate of inflation increases. If economic growth accelerates very rapidly, demand grows even faster and prices continually rise.

In the U.S., inflation is often described as "too many dollars chasing too few goods". In other words, as spending outpaces the production of goods and services, the supply of dollars in an economy exceeds the amount needed. The resulting effect is that the purchasing power of a dollar declines.

**What Causes Inflation?**

Rising commodity prices are perhaps the most visible inflationary force because when commodities rise in price, the cost of basic goods and services will generally increase also. Higher oil prices, in particular, can have the most pervasive impact on an economy. Higher oil prices mean first, that gasoline prices will rise. This, in turn, exerts pressure on the price of all goods and services that are transported to their markets by truck, rail or ship to rise also. At the same time, jet fuel prices go up, raising prices for airline tickets and air transport; heating oil prices will also rise, hurting both consumers and businesses.

By causing price increases throughout an economy, rising oil prices take money out of the pockets of consumers and businesses. Economists therefore view oil price hikes as a "tax" that can depress an already weak economy. Surges in oil prices were followed by recessions or **stagflation** – *a period of inflation combined with low growth and high unemployment* – in the 1970s, 1980s and early 1990s.

**How Does Inflation Affect Investment Returns?**

Inflation poses a "stealth" threat to investors because it chips away at real savings and investment returns. Most investors aim to increase their long-term purchasing power. And, inflation puts this goal at risk because investment returns must first keep up with the rate of inflation in order to increase one's real purchasing power. For example, an

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investment that returns 2% before inflation in an environment of 3% inflation will actually produce a purchasing power loss of 1% when adjusted for inflation.

When it comes to one's investment portfolio, inflation can be particularly harmful to fixed-income returns. Many investors buy fixed-income securities because they want a stable income stream, which comes in the form of interest payments. However, because the rate of interest on most fixed-income securities remains the same until maturity, the purchasing power of the interest payments decline as inflation rises.

Inflation can adversely affect fixed-income investments in another way. When inflation rises, the interest yield required for any new investments in fixed-income securities also tend to rise – either due to market expectations of higher inflation or because the Federal Reserve has raised rates in an attempt to fight inflation. When interest rates rise, bond prices fall. Thus, inflation may lead to a fall in bond prices, potentially reducing total returns on bonds.

Unlike bonds, common stocks have often been a good investment relative to inflation over the very long term, only if companies are able to raise prices for their products when their costs increase. Higher prices may translate into higher earnings. Yet, over shorter time periods, stocks have often shown a negative correlation to inflation and can be especially hurt by unexpected inflation. When inflation rises suddenly or unexpectedly, it can heighten uncertainty about the economy, leading to lower earnings forecasts for companies and lower equity prices.

I originally wrote this prologue in my May 2004 article, "Where Should I Invest". That article was prompted by, then FRB Chairman, Alan Greenspan's decision to begin increasing the Fed Funds Rate after a three year monetary easing following the "dot.com" bubble bursting in 2001. Then, month over month inflation gauges were providing signals of inflationary threats. Today, in comparison, we are hearing concerns about potential runaway inflation that seems far in advance of any such signals.

**If these concerns are valid, how long might it be before we see signs that we are heading towards an inflationary spiral?**

Yes, while a falling US dollar can cause an inflationary effect for goods, services and commodities imported into the USA, it also make US goods, services and commodities more competitively priced in the world markets. This wouldn't necessarily be bad.

The more dangerous and challenging form of inflation occurs when too many US dollars are chasing too few goods. This doesn't seem "in the cards" currently as US consumers just now seem to be coming off of a severe slowdown in spending and banks are undergoing the lengthy process of deleveraging. Given these facts, we probably have more than a year or two before we see this type of inflation happening. And, more likely, we probably have more than a year to react after the Fed begins to take action against any inflationary threat.

**But what if we see the double-digit inflation that the pundits are warning about?**

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In the early stages, it probably makes sense to be overweight international and commodity related stocks. These generally perform best in advance of inflation getting out of hand. Then, as you begin to see inflation gathering momentum, you'll want to gradually start taking profits and accumulate cash. At the same time, you might want to consider how you might hedge your portfolio against falling stock and bond prices. For the reasons I previously articulated, you could certainly expect that a likely outcome will be a stock and bond market crash – eventually. Although, be aware, the stock market usually makes a euphoric upward move before the crash comes.

What about purchasing gold to protect your wealth against inflation? I'm not a big fan of gold. With me, it doesn't hold the luster it has historically had and it just seems that other than for jewelry, it's only a shiny metal. In the investment world, past performance is not always indicative of future results and I'm not one to recommend it as an inflation hedge.

InflationData.com provides and interesting article, at this link: Gold is a "Crisis Hedge" Not an Inflation Hedge. Having no affiliation or financial interest in InflationData.com, I found their article an interesting read and thought you might too.

**Market Update**

If you've been following stock prices since the middle of July, you've witnessed the second of two significant market rallies. The first occurred after the market bottomed this past March. While it is believed that the first rally occurred after it appeared that the pace of the economic downturn was going to decelerate; the second rally seems to be declaring that the economy has bottomed. The current earnings season's reporting can also be considered a contributing factor as well.

Not that company earnings have been anything to write home about. We continue to see overall sales revenue decrease on a year over year basis. What has been more noteworthy, however, is that "bottom-line" earnings have exceeded analyst's expectations for more than 70% of those companies reporting to date. On the other hand, many analysts were more optimistic in their expectations for "top-line" revenue generation.

Nevertheless, many leading economic indicators reflect more positives than negatives – signaling that we are beginning to emerge from this historically deep recession. Oh, what a relief this would be! Yet, it appears that we have a long way to go before we can see any meaningful improvement in the employment statistics.

While both stock and bond markets have continued to rally into the first week of August, I believe that the markets are modestly over-bought for now. Yet, this doesn't mean that prices won't go higher over the short term. This second rally has attracted much investor attention and the previously "scared" money could very well begin moving into the markets and push prices higher. However, there is also the possibility that we could experience a month or two of consolidation until we get a better handle on the pace of any recovery. Don't get me wrong. I am very optimistic that the economy has turned the corner for the better; my concern is that market prices might just be out pacing a recovery.

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Our portfolios lifted higher with July's rally. As such, I am happy to report that our ETF Strategy performance was UP 7.92% for the month of July. On a year-to-date basis, we continue to look pretty good as well. Here are some comparative numbers for you to review:

| | July 2009 | 3 Month | Y-T-D | 1 Year |
|---|---|---|---|---|
| **ELF's ETF Strategy (net)** | 7.92% | 19.54% | 23.07% | -12.81% |
| **S&P 500** | 7.41% | 13.14% | 9.33% | -22.08% |
| **Russell 2000** | 9.53% | 14.18% | 11.46% | -22.09% |
| **MSCI EAFE Index** | 9.05% | 20.20% | 15.19% | -25.09% |
| **MSCI All County World** | 8.67% | 18.16% | 16.89% | -23.02% |

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The ELF ETF Strategy returns presented herein represents a composite of actual results from all client portfolios managed by ELF. Currently, it is the only composite presented by ELF and separate client account portfolio positions are substantially similar, except as may be modified for retirement plan accounts and accounts with net equity of $60,000 or less. There is no minimum account size for inclusion into ELF's ETF Strategy composite and accounts with net equity of $60,000 or less have a tendency to downwardly skew the combined results.

The performance data presented herein includes the reinvestment of dividends and capital gains; as well, ELF's ETF Strategy composite returns are presented after deducting actual management fees, transaction costs or other expenses, if any. ELF charges an annual investment management fee as follows: 1.25% on the first $250,000; 1.00% on the next $750,000; 0.95% on the next $4,000,000; and, 0.75% thereafter.

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