July 3, 2014

UPSURGE IN INFLATION

Dear Investor:

The front line of the battle has now shifted to inflation. There has been a modest pickup in inflation the last two months. It's been enough to catch most people's attention and open the debate on if higher inflation rates have finally arrived and are here to stay.

The Fed has indicated for the past several years they would be willing to let inflation run at their 2% target, or even above, for a short period of time to be certain that the recovery was firmly established. They may be put to the test on that in the near future. Although the first quarter was terrible due to the harsh winter weather across the country, things appear to be back on track. We expect the economy to continue its recovery and perhaps accelerate. This could possibly allow inflation to hit the 2% target or higher.

Although this would put a lot of pressure on the Fed, I think it's very unlikely they will change the time table of the taper. If there was a need to speed up, the Fed could do the last $15 billion at the October 28-29 meeting, which is only four months away.

Overall, the tapering has gone very well, much better than most people were expecting. One of the main reasons for this is demand for US Treasury bonds has been substantial. We are offering much higher interest rates than Germany or Japan, and our economy is stronger. This has helped to keep rates low as the Fed has decreased their bond buying by $50 billion per month now.

There are many signs that indicate the recovery will continue and may pick up momentum. The Case-Shiller data show us that home prices have been rising, and the inventory of homes on the market has been increasing.

The job market has been improving from every angle. New hiring is better with the unemployment rate down to 6.1%. New jobless claims (layoffs) are back to levels seen before the recession. Small business owners have said labor demand is firming and price hikes have also become more common.

A big surprise is in consumer credit. After years of laying low and rebuilding, consumers have started using their credit cards again. The data the last few months has shown that some people are confident enough to increase their spending using debt. While I'm not in favor of this, it seems to be the American way for many.

When we put all these pieces of the picture together, we can sense that we may be very close to the turning point where the economy can finally move forward on its own power. Hand in hand with that could be higher inflation, and a whole new set of challenges.

There's a new term being used that you should be aware of, "liftoff". This will be replacing the news on "taper". "Liftoff" refers to the time when the federal funds rate rises from the current range of

0% - .25%, where it's been for the last 5 ½ years. Most Fed policy makers and economists expect this to take place sometime in 2015. It would take some very strong inflation numbers for it to happen this year.

We appear to be on our way back to "normal conditions". It remains to be seen if these positive trends continue or if we experience some new setbacks. We will be watching the inflation picture very carefully to determine if changes in our strategies are warranted. Please feel free to contact me anytime to discuss your portfolio.

Best Regards,

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