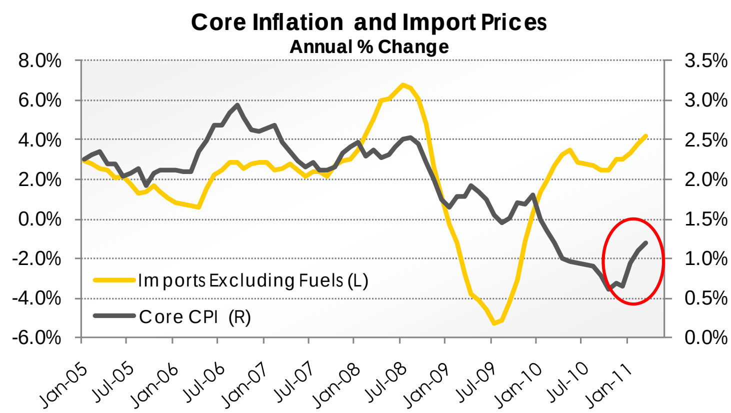
Earlier this year, we wrote about the inflationary pressures building in the global economy due to rising commodity prices. We argued that the Federal Reserve should acknowledge the role that its extended program of quantitative easing has played in the commodity rally, and recognize that American consumers are facing rising prices as a result. Since January, West Texas crude oil has reached over $112 per barrel, and the food component of the Consumer Price Index has jumped from a 1.6% annual growth rate to 2.3%. Even the core rate of inflation, which excludes food and energy prices, has trended higher for several consecutive months as higher input prices feed through the supply chain and are imported to the United States. The rate of core inflation has doubled to 1.2% from its post-recession low in October 2010.

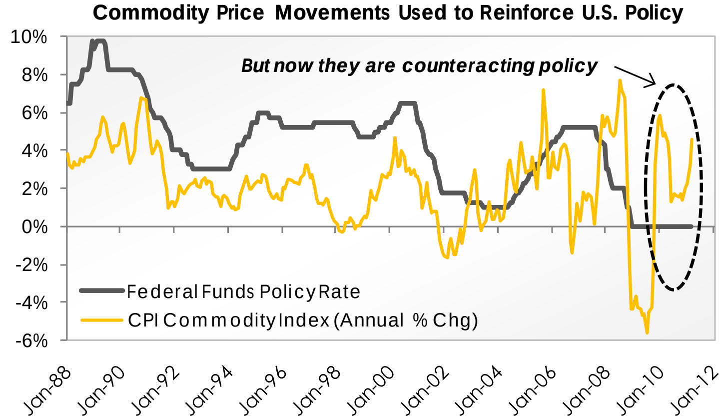


Source: BLS.gov

The early impact of commodity inflation was felt in export-driven countries like China, and they have been acting to combat rising prices for some time. More than twenty central banks have tightened policy already this year, and this trend should continue as fuel surcharges and higher raw material costs bubble through into prices of consumer goods across Asia, Europe, and the United States. Tighter policy in the world's high-growth countries could lead to a global slowdown. If this happens, the Fed may face a dilemma: the U.S. recovery is not yet firmly on track, especially regarding employment, and yet policy makers may need to fight inflation at the same time. Ironically, the longer the Fed keeps its foot on the gas, the longer the U.S. dollar will remain weak, the higher commodity (and headline) inflation will run, and the more growth will slow as central banks raise interest rates. In this research piece, we discuss the transition the global economy may soon experience, and what the implications could be for our portfolios.

Commodities Are Now Counteracting Monetary Policy

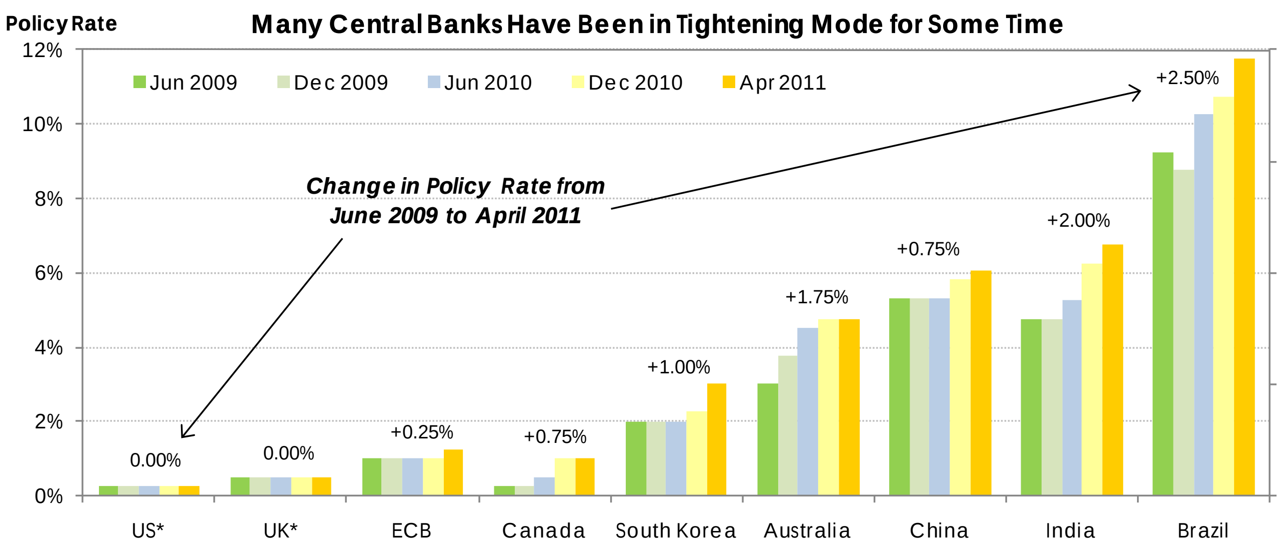
Historically, Federal Reserve policy makers have focused on core inflation when setting monetary policy to target price stability. The logic behind this follows that food and energy prices traditionally have been very volatile, and often influenced by uncontrollable forces like weather patterns. Furthermore, the United States had long enjoyed being the dominant force in the global economy, and commodity prices tended to reinforce, rather than contradict, policy makers' goals. In other words, commodities like food and energy usually were rising when the U.S. economy was overheating, and falling when the U.S. was slowing. The current cycle has been different. The U.S. has struggled to recover from the recession, and the Fed has responded by keeping interest rates near zero for an extended period. Ultra-low rates have depressed the dollar and helped drive up commodity prices, resulting in input price inflation. The Fed is now trying to stimulate domestic growth, but food and energy prices are dragging it down.



Source: bls.gov, Federal Reserve Board

Monetary Policy is Tightening in Most of the World

The Federal Reserve is showing no signs of shifting away from its easy monetary policy stance any time soon. The second round of quantitative easing, which consists of $600 billion in Treasury bond purchases through the end of June, is continuing as scheduled despite relatively-good economic data. Fed Chairman Bernanke also indicated that as the debt held on the Fed's balance sheet matures, the central bank intends to reinvest the capital in new bonds rather than shrink the size of its holdings. This spells continued stimulative conditions in the U.S., and a continuation of policy that weakens the dollar. Meanwhile, in many countries where headline inflation is already escalating, central banks have begun tightening. China, Brazil, and even fiscally-plagued Europe have increased interest rates and/or reserve requirements to combat inflation sparked by food and energy costs.



* US and UK Central Banks also pursued a quantitative easing program to further ease policy
Source: fxstreet.com

The move toward tighter policy in a large portion of the global economy does not bode well for future growth prospects. We have already seen the equity markets in these countries price in slower growth for several months, and it is likely that the trend is headed west. Europe is the perfect example for the challenges the U.S. could face in the months ahead: inflationary pressures, slow growth, and looming fiscal problems.

Inflation is Not Confined to Food and Energy

The European Central Bank has a very straightforward mandate of price-stability, which is what led the bank to raise interest rates last week despite other problems in its economy. The Federal Reserve, on the other hand, has a dual mandate of both price stability and full employment. When determining the level of price stability, the Fed focuses on core inflation excluding food and energy prices. Policy makers have had the luxury of focusing primarily on stimulating growth and employment since core prices have remained fairly subdued, but soon even the core measure could begin to experience upward pressure.

Energy and other commodity prices are not isolated from other segments of the economy. Regardless of the industry, goods must be transported to consumers, which means most goods require fuel at some point in the supply chain. Companies can absorb a certain amount of increase in the cost of transportation, but eventually margins suffer. At that point, a company faces a difficult choice: continue to experience margin compression, or pass along the cost to consumers.

Since the last recession, most companies have opted to absorb cost increases for fear that the consumer could not shoulder them, but lately this trend has started to change. Fuel surcharges have become common practice again, as they were in 2007, and recently companies have begun raising prices on end-consumer goods. A bellwether of the retail industry, Nike, recently announced that it plans to take "significant price increases" across a wide range of shoe and clothing styles to help offset rising raw materials, labor and freight costs[1]. No longer will it make selective price increases by style and market, as Nike has in the past; a significant, across-the-board rise will take effect in spring 2012. Many other companies are following suit, complaining that costs are rising due to expensive cotton, higher fuel prices, and demand for higher wages by laborers in China. Retailers spanning both higher- and lower-end price points have already made the move toward aggressively higher prices, as shown in the table below. American consumers have only seen the tip of the iceberg of inflation.

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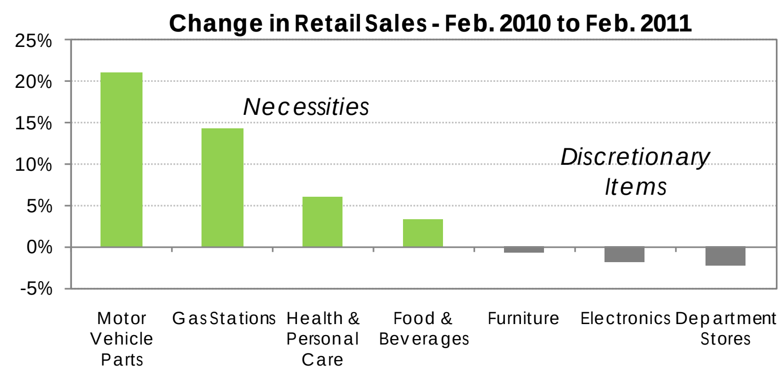
[1] "Nike hurt by cost pressures as it plans price hike," Andria Cheng, MarketWatch

Retailers Are Raising Prices				
Retailer	**Item**	**Old Price**	**New Price**	**% Change**
American Eagle	Striped Polo Shirts	$29.50	$34.50	17%
Charlotte Russe	Swimwear	$14.50	$16.50	14%
Brooks Brothers	Wrinkle-Free Shirt	$79.50	$88.00	11%
Ralph Lauren	Long-Sleeved Men's Shirt	$89.00	$95.00	7%
J. Crew	Women's Gingham Oxford	$69.50	$72.00	4%

Source: "Camouflaging Price Creep," by Stephanie Clifford, New York Times, April 22, 2011

Higher Inflation = Slower Growth

Inflation does not need to rise significantly to become a problem. Consumers are already strapped for discretionary dollars, as higher gas and food prices put strain on household budgets. Necessities such as transportation and personal care items are experiencing increases in sales, while discretionary purchases like electronics and furniture are on the decline. Once consumers experience the effects of higher commodity prices filtering into other goods, the spending slowdown could intensify. This was the reasoning behind the opportunistic addition of the Consumer Staples Sector ETF to our portfolios in recent weeks.



Source: U.S. Census Bureau Monthly Retail Trade Report

Stocks are indicators of future, not current, economic growth. They price in expectations for the economy about six months in advance. Emerging market equities experienced a rough start to the year as the slower-growth expectations dented those markets, and we expect that to begin in the western world in the coming quarters. We expect equities could have a choppy middle-portion of the year as the markets adjust to higher inflation expectations and the potential for a slowing economy. The end of the Fed's bond purchases in June (the second round of quantitative easing) could also throw the markets for a loop. Equities have become quite dependent on the government safety net. We anticipate looking toward more defensive areas of the market if this occurs, similar to the summer of 2010 when the equity rally paused in April. Traditional safe havens such as gold and bonds should benefit from any weakness in equities, and therefore investors should ensure their portfolios are well diversified.

Longer term, the forecast is unclear. U.S. equities turned positive toward the end of 2010 as inflation was falling and Chairman Bernanke announced that the Fed would begin another round of quantitative easing. Now inflation is rising, and the likelihood of additional stimulus is small. The Fed will have some difficult choices to make to balance its dual mandate of price stability (calling for tighter policy to fight inflation) and full employment (looser policy to stimulate growth). We will closely monitor how the equity market digests those decisions, and opportunistically focus on holdings that are defensive and/or produce income.

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