WEALTH MANAGEMENT
MONITOR

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Economic Theme:
Inflation is Creeping Higher Globally

The debate rages on regarding the relative merits of the case for deflation versus inflation. In other words, are price levels more likely to fall or rise during the near-term? With effects of the "Great Recession" still lingering, the deflation argument seems to be supported by headwinds in housing, real growth, employment, and other economic and financial challenges. December's disappointing jobs data contributed to lower bond yields and an increase in risk aversion. Likewise, proposals to re-regulate financial institutions and tightening actions by Chinese monetary authorities have supported bond prices and dented stock valuations.

For the better part of 2009, the deflation scenario reflected a declining trend in Personal Income growth. Simply put, without income growth, demand for goods and service was constrained, and the trend in the Consumer Price Index (CPI) was down as measured year-over-year. The trough in Personal Income occurred in June 2009 when incomes were down by 2.6%. By year-end, income comparisons were nearly flat versus a year earlier but are expected to be up 2%-3% during the first half of 2010. This estimate is predicated upon improvement in the labor market, particularly jobless claims, and continued moderate growth in average weekly earnings. Stronger income growth implies that demand-pull pressures should intensify a bit. As such, the CPI could conceivably be about 2% higher during the first half. The turning point may have already occurred as the CPI in November and December was higher by 1.9% and 2.8%, respectively. This contrasts with negative year-over-year growth for the first ten months of 2009.

From a global perspective, the inflation genie may be out of the bottle as well. Consumer prices in China were 0.6% and 1.9% higher in November and December following ten months of a declining trend. Capacity constraints are emerging in the auto sector, and supply bottlenecks are apparent in electricity, coal, aluminum and steel. Even labor conditions are tightening with employment returning to pre-financial crisis levels. The situation has resulted in banking authorities curtailing lending and in some cases halting loans entirely. A similar trend is evident in developed economies as revealed in the following table:

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Return Expectations

In early January, we made a slight upward adjustment to our interest rate forecast based on higher inflation expectations. We raised the most probable 10-year Treasury estimate to 4.25% from 3.85%. The estimated range is unchanged at 3.15% to 4.50%. In addition to the higher inflation outlook, our rate expectations are governed by the amount of Treasury supply (particularly in 10- and 30-year maturities); the imminent end to quantitative easing and Fed support of Treasury and mortgage-backed bond prices; a slight decline, or, at least, stabilization of the unemployment rate; and stronger personal spending data. The total return from bonds is expected to be about flat on a twelve-month horizon basis. Thus far in January, 10-year bond yields have dropped about 20 basis points reflecting disappointing economic data and an increase in risk aversion. The inflation and interest rate revisions impact our S&P 500 valuation model, resulting in a most probable estimate of 1175 versus 1117. This implies that equities have a moderately more favorable total return outlook versus bonds on a twelve-month horizon basis.

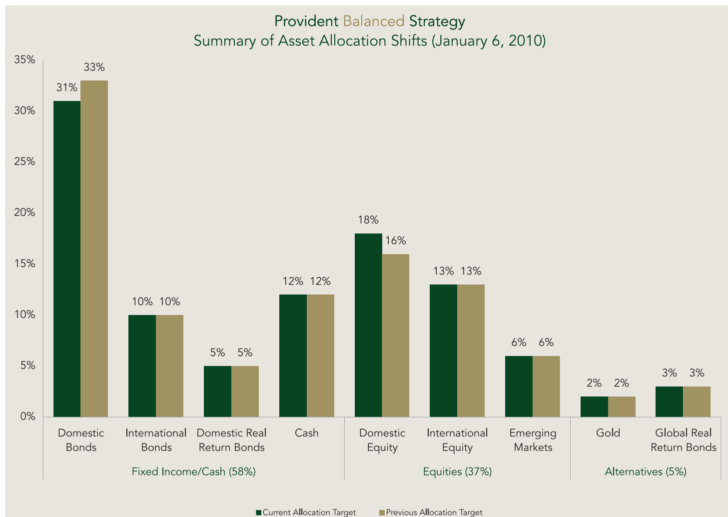
CONSUMER PRICE INDEXES IN TEN COUNTRIES
(% change from same period previous year)

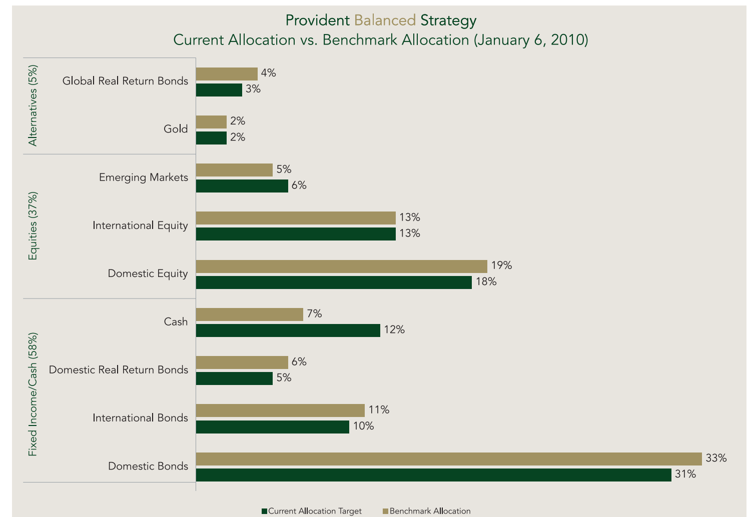
PERIOD	US	CANADA	JAPAN	FRANCE	GERMANY	ITALY	SWEDEN	SWITZERLAND	UK	CHINA
2009										
1Q	0.0	1.2	-0.1	0.6	0.8	1.5	0.8	0.0	-0.1	-0.6
2Q	-1.2	0.1	-1.0	-0.2	0.3	0.9	-0.5	-0.7	-1.3	-1.5
3Q	-1.6	-0.9	-2.2	-0.4	-0.2	0.1	-1.2	-0.9	-1.4	-1.3
Oct	-0.2	0.1	-2.5	-0.2	0.0	0.3	-1.5	-0.9	-0.8	-0.5
Nov	1.9	1.0	-1.9	0.4	0.4	0.8	-0.7	1.4	0.3	0.6
Dec	2.8	1.3	-1.7	1.0	0.9	1.1	0.9	1.4	2.4	1.9

ASSET ALLOCATION RECOMMENDATION

On January 6, we made a modest change in the asset allocation model. Based on return expectations, we reduced exposure to domestic bonds by 2% and correspondingly increased domestic equity exposure by 2%. We are slightly underweight the benchmark allocation in both asset classes. Other asset class weightings and comparisons to benchmark are contained in charts below.

MARKET CLOSES		
S&P 500 Index: 1,092.17	**Dow Jones Industrial Average**: 10,194.3	**10-Year Treasury Yield**: 3.62%





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