BEACON POINTE ADVISORS

BEACON POINTE RESEARCH

THE DEFLATION/INFLATION DEBATE

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CONFIDENTIAL – PROPRIETARY

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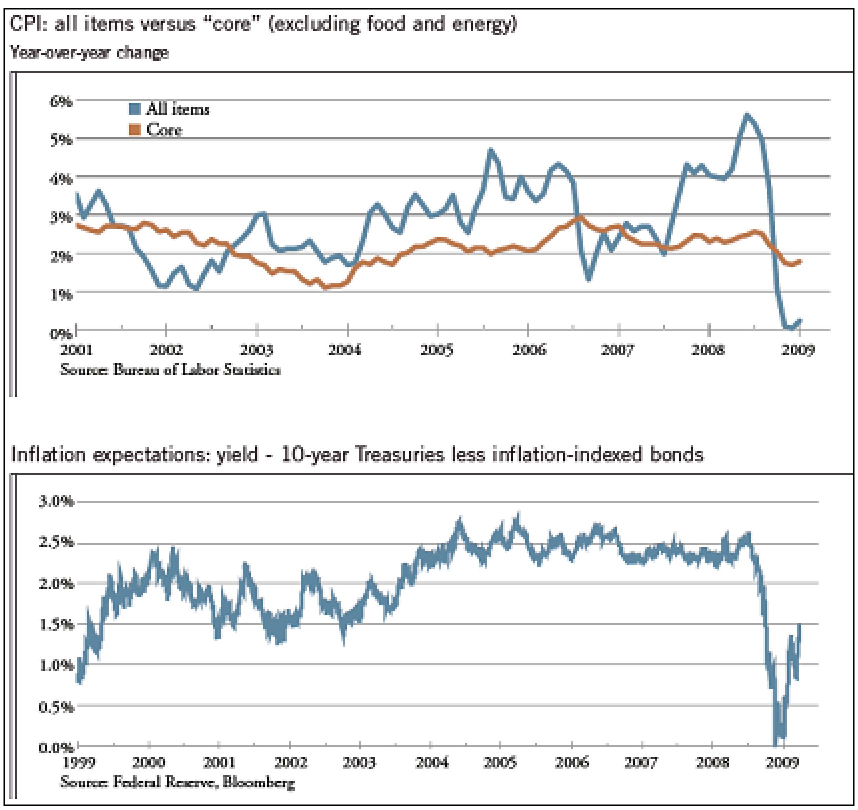
The Deflation/Inflation Debate

The inflation/deflation debate has recently taken center-stage in published media, on Internet blogs, and over the airways around the world. At present, there are two widely divergent opinions, with one side calling for rapidly rising inflation (at the extreme hyperinflation) while the other side still believes that the greatest risk remains deflation. Beacon Pointe surveyed all investment management firms on its Focus List in an effort to gauge their outlooks on inflation and evaluate their strategies to best position client portfolios for what lies ahead. In the following pages we provide a summary of our findings from the investment manager survey mentioned above, our own internal research, and consultations with independent research provides, such as The Leuthold Group, Goldman Sachs, Strategas Research, and others.

After peaking in mid-2008, headline inflation (measured by CPI, all items) has plummeted and helped core inflation moderate to below 2% as well. A general demand weakness, as well as falling energy and food prices, have served as the driving force behind the changing inflation picture. Inflation expectations (measured by the difference between the yield on 10-year Treasuries and TIPS of the same maturities) also took a nosedive, touching negative territory in late 2008. They have rebounded somewhat, as investors evaluate the potential inflationary impact of the numerous fiscal and monetary stimulus programs put into place over the past few months. Nonetheless, inflation expectations remain subdued relative to historical norm, as can be seen in the second chart below.



Source: Institutional Capital

According to Van Hoisington, the "inflationist view of the world seems to rely on two general propositions. First, the unprecedented increases in the Fed's balance sheet are, by definition, inflationary. The Fed has to print money to restore health to the economy, but ultimately this process will result in a substantially higher general price level. Second, an unparalleled surge in federal government spending and massive deficits will stimulate economic activity. This will serve to reinforce the reflationary efforts of the Fed and lead to inflation." Mr. Hoisington argues, however, that inflation will not be a problem for as long as excess labor (as evidenced by the still rising unemployment rate) and capacity (measured by a depressed factory utilization rate) are present in the economy. Since both of these measures of economic "slack" are lagging indicators and will need many years to recover, he believes that inflation will not be a problem for the next decade. Let us now look at the two different sides of the deflation/inflation divide in more detail.

The Deflation Camp

Wikipedia defines deflation as "a sustained decrease in the general price level of goods and services. Deflation occurs when the annual inflation rate falls below zero percent, resulting in an increase in the real value of money (a negative inflation rate). Mainstream economists generally believe that deflation is a problem in a modern economy because of the danger of a deflationary spiral. Deflation is also linked with recessions and with the Great Depression. Additionally, deflation also prevents monetary policy from stabilizing the economy because of a mechanism called the liquidity trap. However, historically not all episodes of deflation correspond with periods of poor economic growth." Lazard Asset Management provided the following exhibit, listing the assets that typically outperform and underperform in deflationary environments and key indicators that characterize periods of deflation:

Outperformers

- Cash
- Sovereign debt
- Equity in companies with strongest balance sheets, cash flow and operational flexibility

Underperformers

- Corporate and asset-backed credit
- Equity in companies with limited operational and/or financial flexibility
- Private equity, due to inability to pay off debt
- Broad range of other assets financed by leverage

Key Indicators

- Failed sovereign debt auctions
- Systemic failure of a currency, e.g. euro
- Protectionism in a different form, e.g. competing guarantees of banking systems
- Trade flow disruptions caused by lack of trade finance
- Extreme increases in unemployment rates leading to lower cost of labor globally

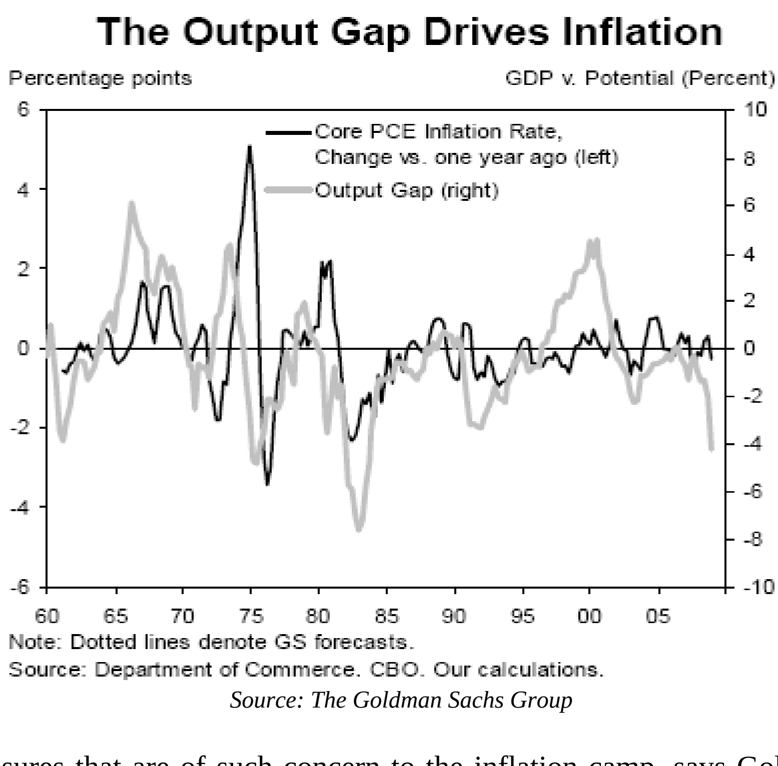
Source: Lazard Asset Management

A number of the managers we surveyed believe that over the short-to-intermediate term, the risk of deflation outweighs the risk of inflation. Oil prices are hovering around $60/barrel, down approximately $85/barrel from their highs. Private deleveraging will continue for several more years as consumers and businesses adjust to the new economic environment. This process of deleveraging is inherently deflationary. With job losses continuing to grow – leading to wage deflation – and consumption remaining at modest levels, significant excess capacity is present in the economy. Consumers have sharply cut spending as they are both over-extended, and fearful of losing their jobs. The savings rate has surged from zero to estimates of 4%-5% as consumers attempt to de-lever and save for potential job-related emergencies. Businesses will grow more slowly and operate with less leverage. While a lot of industrial capacity has been extracted by plant closings, utilization rates continue to be low by historical standards. Banks are lending, but only to those with pristine credit. This will slow down the absorption of homes for sales, particularly at the "jumbo" level. At a minimum, this suggests a sluggish rebound from the current economic contraction.

In response to these economic challenges, the government has resorted to non-traditional monetary policy across a variety of sectors and has dramatically increased the supply of money. In addition to direct purchases of Treasuries, Agency debentures, and Agency mortgage-backed securities, the Treasury and Federal Reserve have introduced new programs such as the Public-Private Investment Program (PPIP) and the Term Asset-Backed Securities Loan Facility (TALF) to provide support and enhanced liquidity to the securities markets.

Van Hoisington, quoted earlier, brings up another argument supporting the deflation camp. Despite the fact that the Fed's balance sheet has doubled in the past year, factors that are outside of the Fed's control, such as behavioral preferences, have kept the money multiplier in check. Banks have grown their reserves significantly above required levels, instead of aggressively expanding their loan and investment activities. Mr. Hoisington concludes: "Economic activity cannot move forward unless credit expansion follows reserve expansion. This is not happening."

Goldman Sachs sees deflation as the main price-related risk facing the U.S. economy in coming years: "This reflects the emergence of the largest output gap [the gap between real GDP and its potential level] in three-quarters of a century. Closing that gap will take years, providing the Fed with plenty of time to restore its balance sheet to a more traditional position."



Source: The Goldman Sachs Group

The government measures that are of such concern to the inflation camp, says Goldman Sachs, are being taken in response to a slump in economic activity that poses the largest risk of deflation since the Great Depression. Goldman Sachs further argues that the Fed can and will counteract hyperinflationary pressures, in the event such occur, by: 1) shelving plans to buy securities; 2) shutting down liquidity and other short-term facilities; and 3) managing current securities holdings by letting maturing issues run off, selling them, or using them to drain reserves via reverse purchase agreements. "The Fed could also lean harder on the Supplementary Financing Program (SFP), seek authority to issue its own debt and boost interest rates on both federal funds and bank reserves if it wanted to keep some of the balance-sheet expansion in place."

One of the investment managers we surveyed argued that the "significant increase in money supply will take one of two avenues. The first, which is the inflation argument, is that the general price level (i.e. CPI) rises as we undergo the traditional inflation scenario of "too many dollars chasing too few goods". The problem with this argument is that we won't have "too few goods" because consumer demand will remain weak as unemployment continues to rise and capacity utilization remains low. Therefore, while there will be plenty of dollars floating around, they won't find their way into consumer prices. We believe that the money supply will follow a second avenue, which is into assets. Specifically, cash will flow into what we call "unencumbered assets" or those companies not saddled with debt".

Another investment manager quoted Treasury Secretary Timothy Geithner: "We have a strong independent Federal Reserve with a very strong mandate from Congress, and they will do what's necessary to keep inflation low and stable over time". Additionally, "injections of reserves into the economy are not going to create the risk of hyperinflation in the future". Whether the government acts in a timely and effective manner to fight future inflationary pressures remains to be seen. However, the Fed and Treasury seem to be keenly aware of the risks and determined to do what is necessary to keep inflation within their target.

Dr. Gary Shilling has been one of the most vocal voices in the deflation camp in recent times. He sees four major deflationary forces in the current environment: 1) weakness in commodity prices, which takes time to work its way through the system; 2) excess inventories, which are the "mortal enemy of price increases"; 3) wage cuts and shorter hours, which we are now seeing for the first time since the 1930s; and 4) excess capacity in the economy, which tends to reduce CPI with a six-month lag. The danger of deflation, according to Dr. Shilling, is that it becomes self-perpetuating: "Consumers see prices declines and delay purchases, which forces retailers and manufacturers to cut back production and labor costs, which drives prices further down". Even when economic growth resumes, according to Dr. Shilling, inflation will be kept in check by central bankers firmly committed to fighting it and by reduced overall liquidity in the system as a result of deleveraging and the reduced role of derivatives in financial markets.

The Inflation Camp

Wikipedia defines inflation as a "rise in the general level of prices of goods and services in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation is also a decline in the real value of money – a loss of purchasing power in the medium of exchange which is also the monetary unit of account in the economy. A chief measure of general price-level inflation is the general inflation rate, which is the percentage change in a general price index (normally the Consumer Price Index) over time. Inflation can have adverse effects on an economy. For example, uncertainty about future inflation may discourage investment and saving. High inflation may lead to shortages of goods if consumers begin hoarding out of concern that prices will increase in the future." Lazard Asset Management provided the following exhibit, listing the assets that typically outperform and underperform in inflationary environments and key indicators that characterize periods of rising inflation:

Outperformers

- Equity in companies with strong balance sheets, cash flow and operational flexibility
- Physical assets
- Selective credit market opportunities

Underperformers

- Sovereign debt
- Cash
- Equity in companies with limited operational and/or financial flexibility

Key Indicators

- Sustained coordinated global intervention on large scale
- Requires complicity of co-dependent trading partners
- Capex reductions across range of commodity producers
- Empowerment of labor leads to higher wages, sustaining inflationary spiral

Source: Lazard Asset Management

A number of the investment managers we surveyed believe that inflation risks are real and forthcoming. Growth-oriented government programs are inherently inflationary and, according to one manager, tend to cut savings' purchasing power in half roughly every 15 years. The U.S. government's plans to inject $10 trillion of new moneys into a $13 trillion economy should eventually jump-start a recovery and introduce inflationary pressures as soon as 2011. The foundation is currently being laid by the Fed and Treasury's unprecedented approach to the crisis, which includes monetary, fiscal, and financial policy stimulus, quantitative easing, and a budge deficit, among other things (e.g. capital expenditure cutbacks restricting energy and metals exploration and production, which will likely lead to inflationary pressures at some point in the future). The various programs have led to significant money supply growth on the order of 12-14% annualized – a level last seen during the 1970s, when inflation reached double digits.

One of the managers we surveyed commented that "eventually, the money printed in such vast quantities to alleviate the current global financial crisis is quite likely to manifest itself as much higher inflation rates than investors have become accustomed to. Investment ramifications will be significant. Interest rates will rise across the entire yield curve, and the purchasing power of cash will be reduced, perhaps dramatically. To this point, massive public cash injections have simply served to help offset the impact of sharply reduced velocity in the money supply. Policy makers are not going to stop until the banking sector and credit markets find some solid footing and the global economy shows clear signs of gaining traction. Ultimately, they will tinker with mark-to-market accounting rules and print as much cash as is necessary to achieve these "win at all cost" mandates. Eventually they will win – and the aggregate banking system will begin to create credit again, at which point the magic of the multiplier effect will begin to hit the money supply. Going forward, we think a much more inflationary environment is likely to take hold."

Another of our surveyed managers provided the following discussion:

> "In the coming months, the federal government is going to be increasing its debt issuance to finance its increased spending as a result of the recently-passed fiscal stimulus program. The Congressional Budget Office is forecasting a federal budget deficit for fiscal year 2009 of about $1.8 trillion. The Fed is on course to create about $2.15 trillion of new credit in the months ahead, as the Fed's

monetization of debt through the purchase of mortgage-backed securities, Treasury securities and the TALF program in conjunction with the federal government's increased spending will almost certainly generate stronger economic activity. This increased economic activity will be from borrowing and lending as opposed to saving and producing.

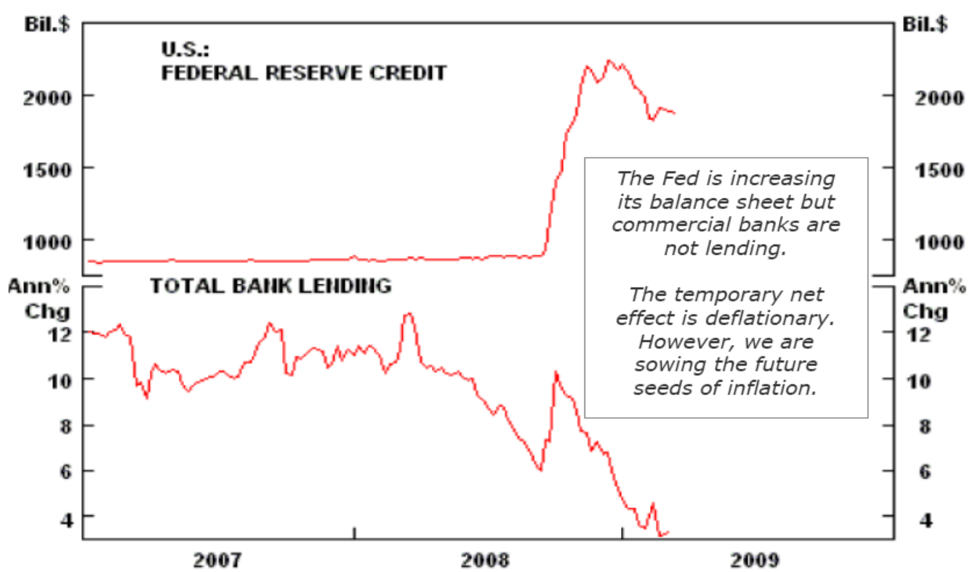
Currently, the United States, along with its trading partners, is experiencing some deflation. The markets are slowly trying to destroy the massive debt that has been built up over years due to bad government policy. The velocity of money is falling so rapidly (people trying to save money), that the Fed has had to try to counteract by creating more supply.

Deflation ends when savers, once again, see a reasonable return for risk. This requires prices to come down. When savers finally see property cheap enough, materials cheap enough, and labor cheap enough, they will invest. However, that will take time--the debt pool is still enormous when compared to the savings pool.

Large fiscal deficits combined with expansionary monetary policies have always been the ideal mixture for future high consumer price increases. When a country is faced with a recession, every government (particularly democratically elected governments) seeks to intervene, usually cutting interest rates and allowing fiscal deficits to grow.

Initially, this government action may not be problematic. However, the central bank is often slow to increase rates to control excessive credit growth in the system. This was true after June 2004, as interest rates were lifted very slowly, with Fed Fund rates lagging behind both nominal GDP growth rates and cost of living increases. The unintended consequence of this policy is the credit / housing bubble which has come to roost.

In our view, this monetization of debt is inflationary and confirmation that the Federal Reserve seeks to debase the U.S. dollar. The total debt, including future liabilities, of the United States now exceeds $60 trillion. Given our annual GDP is approximately $14 trillion, the only way the United States can ever repay this debt is through monetary inflation and debasement.



> Given the magnitude of projected government debt, coupled with $1 trillion fiscal deficits for years to come, we contend that the Fed will keep short-term rates artificially low. Like the credit / housing bubble, we anticipate that we will once again be forced to confront serious unintended consequence."

A potential dollar weakness if the U.S. currency is no longer the international store of value would further exacerbate inflation. According to one manager, "The decision by the Fed to purchase long-term Treasury bonds and mortgage securities has been met by more vocal posturing by China and Russia to replace the dollar as the international reserve currency. Furthermore, the Chinese want some form of guarantee on the purchasing power of their dollar holdings on the order of TIPS. The reality is that the U.S. Government has a tremendous amount of debt to issue and rollover to finance the stimulus package and the current account deficit. Should buyers curtail their appetite for U.S. debt, the impact on the dollar and inflation could be unprecedented."

And what about the willingness and ability of the Fed to reign in inflation? As one manager put it, "by the time the Fed tries to unwind its monetary policy, the inflation genie will be out of the bottle." Another manager pointed out that the Fed's balance sheet is crowded with potentially less liquid credits, reducing its flexibility to fight inflation in the future. According to The New York Time Op-Ed contributor Allan Meltzer ("Inflation Nation", published May 4, 2009), the Federal Reserve knows "only two speeds: too fast and too slow". He acknowledges that Fed members are well aware of the harmful effects of inflation and are verbally committed to keep it in check. But in the past, when anti-inflationary moves have resulted in rising unemployment rates, the Fed tended to forget its promises and refocus on expanding the money supply and reducing interest rates. In short, the Fed's past track record, to this observes, is not very promising. At least until Paul Volcker came to the rescue in 1979. The question then centers around how will <u>this</u> Fed respond. It seems that only time will tell.

Beacon Pointe's Position

Given that both inflationists and deflationists present some good arguments, we found that neither side can claim a convincing victory yet. On balance, over the next 1-2 years deflation appears to be the bigger risk for the U.S. economy. Looking beyond that, however, inflationary risks may gain the upper hand over the 3-5 year horizon. Granted, the extent to which deflation or inflation impact the economy and investment returns will depend on many as-yet unknown factors, including the length and depth of the current recession, the success of the government's reflationary programs, business and consumer reactions to the crisis and eventual recovery, the shape of the recovery, the status of the U.S. dollar, economic developments in the developed and emerging world, and the Fed's ability and willingness to reverse its course once the U.S. economy turns a corner.

With so many moving parts and unknowns, Beacon Pointe is not recommending any major shifts in clients' asset allocation targets or manager line-ups. Instead, we may propose subtle changes over time and subject to new information as it becomes available in the future. From an asset allocation perspective, in some client portfolios we have added or are contemplating an allocation to commodities and, more selectively, to private or public real estate. From a manager selection perspective, most of the managers we recommend are bottom up stock pickers, doing extensive due diligence on companies under various economic scenarios, including deflationary and inflationary environments. Their growth expectations are adjusted accordingly; their valuation assumptions also change, depending on the specific inflationary dynamics, both present and anticipated. We are confident that these managers will reposition their portfolios properly for either an inflationary or deflationary environment that would manifest itself in the coming years.

Beacon Pointe asked the investment managers we surveyed to provide specific examples of strategies used in their portfolios to protect client assets against potential inflation. Here is a sample of their responses:

- This equity manager is focused on asset-rich companies that have responsible balance sheets and are generating cash. These companies' management teams have a reasonable plan to position these assets to compound equity returns for shareholders regardless of the inflation environment.

- This equity manager has concentrated the portfolio in highly profitable companies that can self-fund their growth and not be completely reliant on the capital markets to finance themselves. Companies that can self-fund their growth and are not overly leveraged will garner the lion's share of the liquidity that has been generated by the Fed and Congress' actions. This is where "inflation" will occur. While consumer prices will decline, asset prices will rise and the biggest increase will occur in these unencumbered areas.

- This equity manager has been increasing its investments in defensive businesses like education, health care, infrastructure, business services, and utilities, whose growth prospects are favorable despite a challenging economic environment. At the same time, it has been reducing its investments in businesses that are more sensitive to the current economic conditions.

- As a hedge against future inflation, this equity manager has chosen to position the portfolio in gold mining stocks, which currently represent about 15% of the portfolio.

- This equity manager seeks to populate its portfolios with companies that are not only likely to survive a depression (due to their strong balance sheets, lack of excessive leverage, and overall financial strength) but also structured to outperform during inflationary cycles as a result of their non-capital intensive business models and pricing power. During inflationary periods, capital intensive companies that have to continually reinvest large portions of their earnings just to tread water tend to dramatically underperform. Conversely, businesses that have modest maintenance capital expenditure requirements tend to dramatically outperform during inflationary periods because more of the earnings growth is real and can accrue to the benefit of shareholders. The investment team also looks for companies with competitive advantages or a "business moat". Usually, attributes that render the product or service unique also manifest themselves in brand loyalty, which is a positive in all economic environments. Such moats can shield businesses during recessions and can afford pricing power during inflationary periods. In summary, this manager's selection process has embedded inflation protections. In addition, as an alternative to holding cash, it currently holds gold and silver ETFs. These investments are believed to be attractive and prudent for two reasons: (a) gold and silver should hold their purchasing power during an inflationary environment, and (b) with money markets yielding close to zero, they represent a positive risk/reward tradeoff.

- This equity manager thinks long and hard about "inflation" as it pertains to firms' "pricing power". Getting this micro-economic aspect of inflation right is abundantly more important than an estimate (guess, speculation) on macro inflation. Specifically, the manager endeavors to own companies that exhibit pricing power, and/or have a business model that is less susceptible to margin contraction via volatile input cost/inflation.

- This equity manager seeks to understand which assets will maintain purchasing power in an inflationary environment and believes precious metals and other commodities with intrinsic value could appreciate considerably. Additionally, the values of fundamentally sound businesses with (1) clean balance sheets and/or (2) a degree of pricing power for their goods or services could also rise substantially as a result of inflation. The firm often focuses on a "sum-of-parts" approach to stock analysis for a portion of the portfolio, preferring well-managed companies with ownership of hard assets such as timber, pipelines, power transmission assets, and certain types of real estate. Just as with precious metals, hard assets tend to do well in inflationary environments. Further, if the operator is skilled, the portfolio should enjoy significant yield coupled with overall NAV appreciation. Similarly, it is paramount that its portfolio companies have discernable competitive advantages with business models which function well in an inflationary environment.

- This municipal fixed income manager has been keeping the duration short to the index, looking to maintain duration of 3.5-4.5 years (being shorter than this will sacrifice a fair amount of yield due to the steepness of the yield curve). The laddered structure of the portfolio allows for continuous maturities being invested into a rising interest rate environment.

- This fixed income manager will maintain portfolio duration below benchmark duration since rates are likely to rise from these levels. Furthermore, given Fed Funds near zero and elevated long-term inflation expectations, it will maintain positions which benefit from a steepening yield curve. In total return portfolios, it also holds a small allocation to TIPS (Treasury Inflation Protected Securities). However, while TIPS offer attractive relative value when compared to nominal Treasuries, yields are not as compelling versus non-government fixed income asset classes. Furthermore, the TIPS sector does not have the liquidity of the nominal Treasury market. The firm will maintain its exposure to TIPS in anticipation of increasing inflationary pressures over time, but is not likely to increase their portfolio weight significantly, relying instead on duration and yield curve positioning to further articulate its longer-term inflation views.

- This fixed income manager believes that commodities and Treasury Inflation-Protected Securities (TIPS) are currently two sectors that can provide investors diversification as well as exposure to sectors that may benefit from future economic developments. Despite the price declines seen in both of these markets in the second half of 2008, the firm believes that they are poised to recover in the medium term, when economic growth and inflation begin to increase.

- This diversified manager believes that a high-quality global investment strategy that includes allocations to TIPs, real estate, commodities such as gold and timber, energy companies, and infrastructure can serve as an inflation hedge. But not all of these are all-weather hedges. For example, real estate is a hedge to inflation long term, but not in the short-term if oversupply is an issue. So an investor must be prudent in picking the hedging classes that will work in a particular environment and develop a "smart" asset allocation to inflation-hedging instruments.

In summary, Beacon Pointe believes that inflation is likely to remain moderate in the near term (12-18 months) while the U.S. economy and financial system are recovering. Inflation beyond this point will be determined by how effectively monetary easing policies are reversed once economic conditions normalize. We will continue to monitor all relevant indicators and update our clients periodically. While we may propose subtle shifts in our clients' asset allocation targets over the coming years, we believe that the managers we recommend are well positioned to protect client assets against possible future inflation.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.