

## 2<sup>nd</sup> Quarter 2008 Market Commentary and Outlook Inflation, Finger Pointing & The Declining Dollar

The two month “don’t fight the Fed” rally which lifted the S&P 500 12% from the March 17<sup>th</sup> Bear Stearns induced bottom, was unceremoniously terminated mid-May with Federal Reserve Chairman Ben Bernanke’s following comments *“If people expect an increase in inflation to be temporary and do not build it into their longer-term plans for setting wages and prices, then the inflation created by a shock to oil prices will tend to fade relatively quickly.”* He continued, *“Some indicators of longer-term inflation expectations have risen in recent months, which is a significant concern for the Federal Reserve. We will need to monitor that situation closely. However, changes in long-term inflation expectations have been measured in tenths of a percentage point this time around rather than in whole percentage points, as appeared to be the case in the mid-1970s. Importantly, we see little indication today of the beginnings of a 1970s-style wage-price spiral, in which wages and prices chased each other ever upward.”*

### Inflation a Global Problem

Bernanke’s comments signaled to the market that the nine month easing cycle was essentially over after reducing the Fed funds interest rate seven times from 5.25% down to 2% (in one of the most rapid rate-cutting cycles ever!). These comments were also his attempt to retain credibility as an inflation fighter and acknowledged that the U.S. had entered **Stage One** of an inflationary cycle. With the continued decline in the dollar and the resulting impact on import prices, including food and energy, the U.S. consumer is really bearing a significant tax on their standard of living. Consumers in the U.K and globally are experiencing a similar burden as outlined in recent comments by Mervyn King, head of the U.K central bank. *“This year our real take-home pay will rise at a slower pace than national productivity. Rising fuel, gas, electricity and food prices, mean that average real take-home pay will stagnate this year. It will not be an easy time, and I know that some families will find it particularly difficult. The squeeze on real take-home pay will arguably be an even more significant restraint on consumer spending this year than the credit crunch. But to return now to inflationary pay settlements would undermine rather than raise people’s living standards with a damaging circle of wage increases eroded by steadily rising prices.”*

Mr King’s ending note refers to the desire to avoid the destructive price/wage spiral that develops in **Stage Two Inflation**. In Stage Two, expectations become imbedded in consumer psychology and households attempt to recoup costs via wage increases. Unfortunately across much of the globe we are already seeing high single and, in some cases, double digit inflation rates, Vietnam 26.8%, Saudi Arabia 10.5%, Indonesia 10.4%, China 7.7%, Iceland 12.7%, Venezuela 30%, Russia 14.3% and finally Zimbabwe at 100,580% (this is not a misprint). Unfortunately, in these high growth economies, the labor force is developing much more clout and recovering cost of living increases is high on the priority list for labor forces.

**Asset Allocation for Inflationary Times**

In classic Beaumont “hope for the best yet prepare for the worst” fashion, our client’s are positioned to avoid the devastating effects of just such a corrosive inflationary environment. One can see from the asset allocation chart below the significant allocation that total Beaumont has in the real asset category (highlighted in yellow). Our 32% allocation rivals that of other “smart” money asset allocators including the Harvard and Yale endowments, which were also early to position for this macro investment theme.

| <b>Asset Allocation</b>             | <b>*BFP</b> | <b>Harvard</b> | <b>Yale</b> |
|-------------------------------------|-------------|----------------|-------------|
| <b>Equity</b>                       |             |                |             |
| <b>U.S. Equity</b>                  | 15%         | 12%            | 12%         |
| <b>Non-U.S. Equity</b>              | 7%          | 19%            | 15%         |
| <b>Total Equity</b>                 | 22%         | 31%            | 27%         |
| <b>Fixed Income</b>                 |             |                |             |
| <b>U.S. Fixed Income</b>            | 15%         |                |             |
| <b>Non-U.S. Fixed Income</b>        | 6%          |                |             |
| <b>Total Fixed</b>                  | 21%         | 13%            | 4%          |
| <b>Alternative Investments</b>      |             |                |             |
| Real Estate & REITs                 |             |                |             |
| <b>Real Assets</b>                  | 32%         | 31%            | 27%         |
| Private Equity/Venture Capital      |             | 13%            | 17%         |
| <b>Hedge Funds or Fund of Funds</b> | 11%         | 17%            | 25%         |
| Inflation-Indexed Securities        | 1%          |                |             |
| <b>Total Alternative</b>            | 44%         | 61%            | 69%         |
| <b>Cash/Cash Equivalent</b>         | 13%         | -5%            | 0%          |
| <b>Total</b>                        | <u>100%</u> | <u>100%</u>    | <u>100%</u> |

\*The above BFP allocation represents a composite view of BFP managed accounts. BFP individual client allocations will vary depending upon client objectives, investment goals, risk profile, time horizon and other factors.

### Under the Category of “Johnny-Come-Lately”

The California Public Employees' Retirement System (CALPERS), the nation's largest public pension fund, is among those institutional investors moving into real assets. Beginning early last year, CALPERS increased its exposure to commodities as a way to diversify its portfolio. Such investments are now valued at \$1.1 billion of its nearly \$247 billion in total investments. **"In our book, it is not what we call speculation," said CALPERS spokesman Clark McKinley. "We took a long time to get into this market and we have a long time frame in our investment window left,"** which McKinley says runs 10 to 12 years. At less than one percent of total assets, CALPERS obviously has some serious catching up to do and recently announced their intention to raise this allocation to 3% of portfolio assets.

### Finger Pointing In Washington

Recent hearings held in Washington by lawmakers looking to divert attention from failed energy and fiscal policies have attempted to make the case that “speculators” are behind the recent rise in energy prices. Proposals in both the House and the Senate are being made in an attempt to respond to voter’s anger over soaring fuel prices. Unfortunately, when it comes to debate on the so-called “speculators”, Washington fails to address the fact that we have not replaced any of the oil reserves the world has consumed for the past 20 years. Gerald F. Seib, assistant managing editor for *The Wall Street Journal*, commented recently that “the real energy shortage in America exists in its lack of political leadership willing to do something constructive about this issue.” He highlights Rep. Randy Forbes (Virginia) who has distinguished himself by calling for a “Manhattan Project” approach to fully end the U.S. dependence on foreign oil within 20 years. He then goes on to note that, instead of real debate, we have the same tired repeat of 20-year old arguments about opening offshore drilling efforts and a series of Congressional hearings on the role speculators have in driving up the price of oil which have nothing to do with tackling the energy problem.

### The Dollar, The Real Culprit

Again, the reality in this global cost spiral is failed Washington trade, energy and fiscal policies. The inflation that we are experiencing now is driven by the declining value of the dollar, not speculators. Most global commodities are priced in dollars. The dollar has been falling since 2002 and the imbalances facing the dollar are still large. The domestic money supply, as measured by M3, is growing at 14% per year while the U.S. debt to GDP ratio is increasing at an alarming rate. Currently, the U.S. has over \$50 trillion of debt on top of a GDP base of \$14.1 trillion (as discussed in our last quarterly letter). While the lower dollar is helping exporters, these gains are being more than offset by the rising cost of imported oil. According to Michael Phillips of *The Wall Street Journal*, the U.S. has to import on net almost \$2 billion in capital a day to cover its trade gap. Of the \$920 billion that foreigners pumped into U.S. stocks, bonds and government securities last year, 40% came from emerging market nations. China alone accounted for over 20% of the total. **“Not only are we addicted to others peoples money, but the money we’re addicted to is from the poor countries”** per Phillips. The most worrisome trend is that essentially the whole burden of supporting the dollar is left to countries with pegged currencies that have much stronger

growth rates and are suffering from very high inflation. Going forward, these countries are increasingly less likely to keep their currencies in line with the dollar. Capital normally flows from slow growing, rich countries that have plenty to fast growing, poor countries that don't. In short, the U.S. need for foreign capital has narrowed moderately, but the ability of the U.S. to attract capital has deteriorated even faster. The weakness of the U.S. economy is helping to reduce the trade deficit, but it is having an even bigger impact on the ability of the U.S. to attract capital. This is a key investment theme that will take years to work its way through and again, Beaumont's clients are well positioned to capitalize. It is an exaggeration to say 100% of our investments are exposed to this theme, however, the number is very high and will be a critical driver of performance going forward.

### **Strong 2<sup>nd</sup> Quarter and Year-to-Date Results Driven by Asset Allocation**

The S&P 500 total return was down 2.7% in the 2<sup>nd</sup> quarter and is down 12% on a year-to-date basis. The MSCI World Index (ex-US) total return was flat during the 2<sup>nd</sup> quarter and off 14% on a year-to-date basis. What started as a U.S. housing/credit market collapse morphed into a global financial crisis with double digit declines experienced in many markets around the world. Beaumont has always been focused on generating absolute returns. On a relative performance basis, we are very pleased with our positive 2<sup>nd</sup> quarter and year-to-date results which can be attributed to our diversified asset allocation effort and defensive positioning. For example, our decision to sell a large portion of our emerging market equities and rotate the proceeds into emerging market currency exposure has served us well during the first half of 2008. As previously mentioned, with inflation continuing to increase in developing nations, it is only a matter of time before emerging market interest rates rise resulting in a strengthening of the underlying local currencies versus the dollar.

Heading into the second half, we anticipate that the markets will continue a seesaw pattern as the markets attempt to discount the depth and length of the economic slowdown caused by the housing collapse. With this outlook we will stay the course with the current asset allocation which includes significant inflation protection and larger than normal cash positions allowing for principal protection and opportunistic asset purchases.

If you have any questions or comments please contact us at 781-237-7170 or e-mail me at [mstack@bfpartners.com](mailto:mstack@bfpartners.com).

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