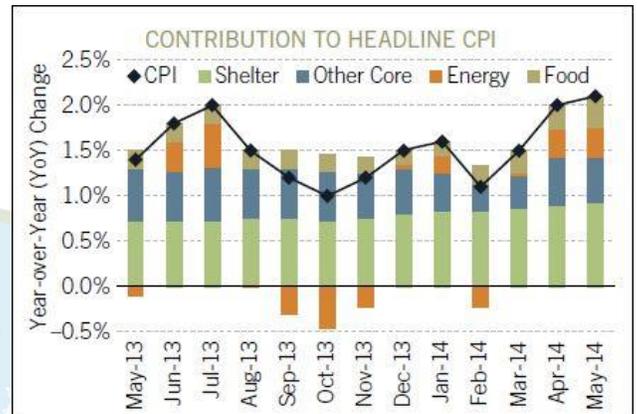


### Inflation: Real Problem or Nominal Worry?

Over the last few years, inflation has been a popular talking point among economists and investment experts. Some believe the Fed's loose monetary policy and large-scale quantitative easing program will lead to rampant inflation. Others feel we are unlikely to see any type of real inflation for years to come. As a firm, we fall somewhere in the middle and think inflation will likely be contained for the near term. With that being said, going forward we see an increased potential for inflationary surprises.

### What is the Consumer Price Index (CPI)?

The most common measure of inflation used is the headline Consumer Price Index (CPI), which is released monthly by the Bureau of Labor Statistics (BLS). The index attempts to track the prices consumers pay for a variety of goods over time. It's made up of 8 major groups including: food & beverage, housing, apparel, transportation, medical care, recreation, education & communication and other goods & services. Each of these groups is then broken down into roughly 200 categories in order to get the most accurate reading.<sup>1</sup> The chart to the right, created by Fidelity Investments, provides a simplified version of the key components of headline CPI and shows how volatile the food and energy categories can be. Lastly, core CPI, which is also used as a measure of inflation, is simply the headline CPI less food and energy.

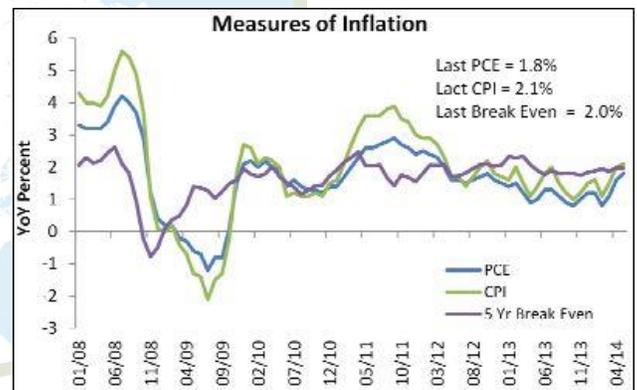


Source: Fidelity Investments

### Inflation's recent path and future

One can see on the chart to the right that inflation has been relatively muted since mid-2008 and has remained below the Fed's target rate of 2% during the current economic expansion.<sup>2</sup> Many economists attribute this to the relatively slow economic growth the US has experienced since the end of the "Great Recession" in mid-2009. Additionally, many experts feel that US growth will remain measured, keeping inflation low.

We agree with the first assessment, but think the recent pickup in global economic growth, coupled with overly accommodative central bank policies, point toward higher future prices. Specifically, we see an increased likelihood of surprises to the upside related to the food and energy portion of the CPI data.



Source: DoubleLine Capital

As the global economy continues to strengthen, we think both consumer and industrial demand have the potential to drive commodity prices higher. We've also seen a recent increase in global unrest which typically leads to higher energy and precious metals prices. This comes at a time when commodities as a group have underperformed other areas of the market over the last few years and appear undervalued. Finally, many economists project that we are now in the latter half of the current business cycle, a stage where the commodity sector has historically performed well.<sup>3</sup>

**Preparing for the future**

The current situation and near term outlook have led us to make recent changes to our client portfolios. We have added a small commodity allocation through use of an actively managed ETF strategy. It provides broad based exposure to many commodities and is not constrained to an index.

Our goal with this new allocation is to increase portfolio diversification in hopes of reducing risk, experience price appreciation from an undervalued asset class, and protect our client's purchasing power in the event that rising inflation rates become the new norm.

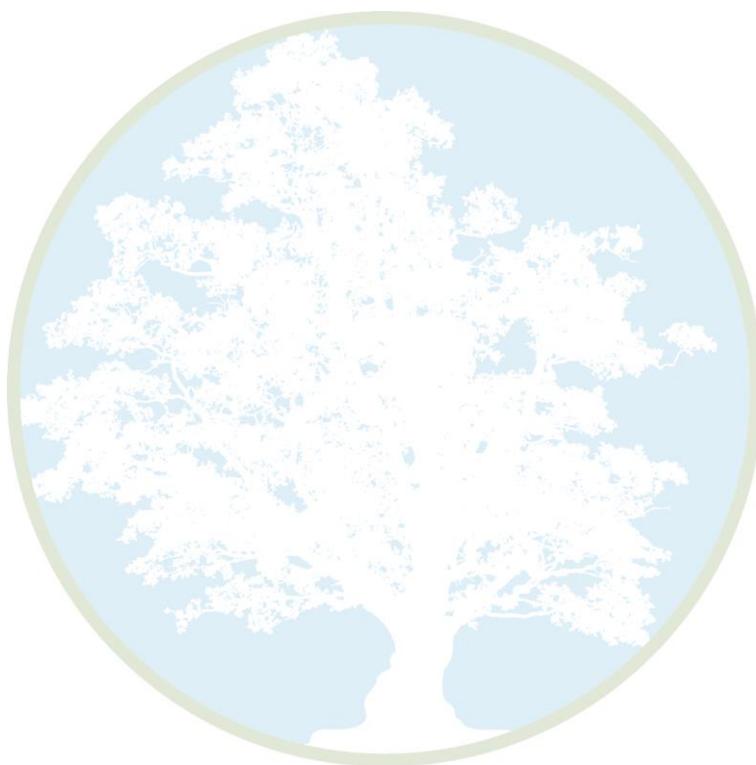
Please feel to contact us with any questions you may have.

**Matt B. Bailey, CFA**

Portfolio Manager

**Sources:**

1. [www.bls.gov](http://www.bls.gov)
2. DoubleLine Capital
3. First Trust



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