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MONTHLY

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IS INFLATION A PROBLEM?

Introduction

Most people are acutely aware that oil and commodity prices have risen sharply since the end of 2001. Some of this clearly is due to a rebound in the global economy from the start of the decade. This strong growth has resulted in a significant increase in demand for commodities from developed and emerging countries. In the past, this kind of sharp run-up in oil and other commodities would have stoked inflation fears – concern that higher commodity prices will feed into prices of other goods and services.

In this *Monthly,* we show that higher commodity prices alone should not produce a long-term inflation problem. Instead, the factor that is most important in the long-term outlook for inflation is monetary policy.

History

Figure 1 shows that there has been a relationship between oil prices and inflation. But there is significant evidence that inflation has become less sensitive to oil prices over time as energy importance in the US economy has fallen.

Increases were experienced in both oil and the Consumer Price Index (CPI) on a number of occasions: the OPEC and Iran hostage crises (1973-74, 1979), the Kuwait invasion and subsequent Iraq war (1991), and the most recent increase. Likewise, there were a number of instances when both oil and consumer prices were soft: 1985-86, 1991-92, and 1997-98. These were largely times of global slowdown or recession.

Apart from the 1970s, when OPEC restricted supply and drove oil prices higher (known as an adverse or negative "supply shock"), much of the movement in oil

(Continued on page 2)

CURRENT TOPICS

Is Inflation a Problem?

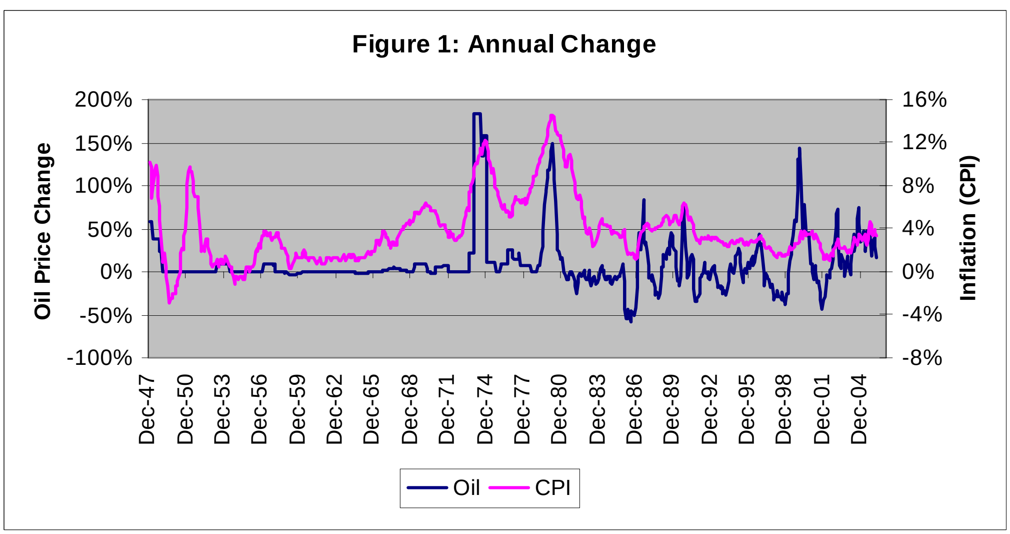
- *Introduction*
- *History*
- *"Theory" and Fact*
- *Market Expectations*
- *Looking Ahead*
- *Conclusion*

WEB UPDATE

In May we updated the appearance of our web site.

STRATEGY

There were no strategy changes in the month of May. We remain underweight non-US equities.



Sources: Haver Analytics, Bureau of Labor Statistics, Stairway Partners

"INFLATION HAS BECOME LESS SENSITIVE TO OIL PRICES OVER TIME AS ENERGY IMPORTANCE IN THE US ECONOMY HAS FALLEN"

Is inflation a problem? - cont'd

(Continued from page 1)

prices can be attributed to economic conditions. When the global economy has been strong, oil prices have reflected the robust demand; a weak economy has typically been reflected in cheaper oil.

"Theory" and Fact

In the 1970s, the OPEC supply shock, which drove oil prices much higher, contributed to the inflation problem. Given the political risk in a number of oil producers, such as Russia, Venezuela and Nigeria, a supply shock cannot be ruled out. This risk is partially responsible for higher oil prices.

It is our belief that most of the gain in energy prices has been driven by strong growth and its related demand. In any case, the gain in oil prices is a change relative to other goods and services, and not the cause of higher general inflation.

If oil and commodities are not the driver of inflation but a by-product of economic growth, then what does cause a long-term inflation problem?

Figure 2 demonstrates that, over long time frames, the primary cause of inflation is excess growth of the money supply. A certain amount of growth in money is needed simply to match the real growth in the economy. However, if the money supply is allowed to expand significantly faster than economic growth, we find ourselves in the classic situation of "too much money chasing too few goods". In other words, excess money leads to inflation.

The chart shows that this pattern holds reasonably well: inflation rose when money supply growth was rising and fell when money supply growth was declining. This relationship did not work as well in the early 1990s – based strictly on the growth of the money supply, inflation should have been even lower than it was.

Nevertheless, we can say that monetary growth over the last few years is consistent with CPI inflation of 2.5% to 3.0%, which is somewhat above our long-term inflation estimate and roughly in line with expectations in the bond market.

What else might we conclude from this relationship? While it is true that oil prices can have temporary or one-off effects on inflation (perhaps even resulting in disinflation or deflation), they will not be long-term influences unless the Fed allows a problem to develop. In other words, higher energy costs should not be long-run inflationary unless monetary policy is accommodative in an attempt to keep "expensive" oil from having harmful effects on the economy, as in the 1970s.

Market Expectations

We can look to the Treasury bond market for estimates of future inflation to either confirm or deny our thesis. The difference between the yields on conventional bonds and Treasury Inflation Protected Securities (TIPS) can be used as a good estimate of what financial markets expect inflation to be.

Figure 3 shows this difference – called the "breakeven" inflation rate – for 10-year Treasury bonds and TIPS, and compares it to the actual 12-month change in the CPI inflation rate. It is interesting to note that market expectations for 10-year inflation respond to the recent infla-

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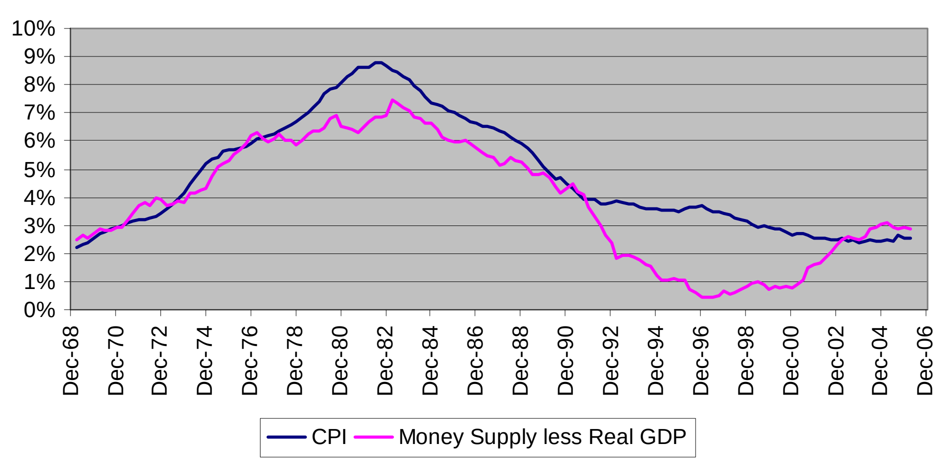
Figure 2: 10-Year Inflation & "Excess" Money Supply Growth



"OVER LONG TIME FRAMES, THE PRIMARY CAUSE OF INFLATION IS EXCESS GROWTH OF THE MONEY SUPPLY"

Sources: Haver Analytics, Bureau of Labor Statistics, Federal Reserve, Bloomberg, Stairway Partners
Notes: Quarterly data through 3/31/2006. Inflation and money supply growth are 10-year averages. Money supply is M2 definition.

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

tion experience: for example, expectations fell in the late 1990s as inflation was coming down. However, long-term inflation expectations remained above the actual inflation rate until the flight to quality into liquid Treasury bonds during the crisis in 1998 when Russia defaulted and Long Term Capital Management (a large hedge fund) imploded.

Even during the deflation scare in late 2002, when inflation fell to 1% and there was considerable talk of a Japan-style deflation problem, longer-term expectations remained mostly in the 1.5% to 2.0% range. They were "well-anchored" to the relevant long-term horizon.

More recently, despite substantially higher oil prices feeding into higher CPI inflation (which has been above 4% in the last year), long-term inflation expectations have been relatively stable around 2.5%. It would appear as though the market is looking through oil as a (more or less) transient phenomenon.

Looking Ahead

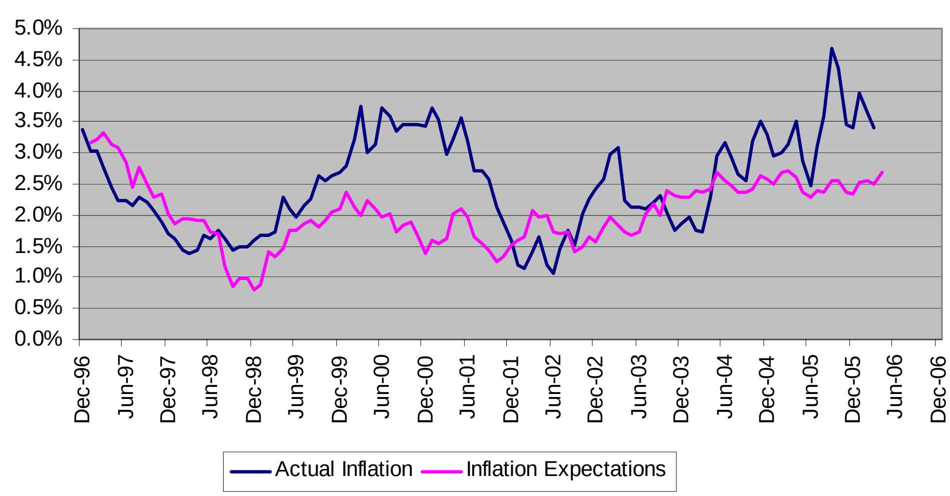
We agree with the market assessment on this point, because we acknowledge that inflation in the long run is primarily a monetary phenomenon. Further, we do not believe that Fed Chairman Bernanke will willingly or easily allow the Fed's inflation-fighting reputation to be damaged.

In recent weeks, the press has certainly called his inflation "hawkishness" into question. But for years, Bernanke has stated that low and stable inflation is the best way for the Fed to assure economic growth and stability. In addition, the lessons learned from the poor monetary policy that led to the inflation problem of the 1970s are well known by the Federal Reserve and the financial markets.

Conclusion

In the short run, market participants may question whether higher oil and commodity prices will lead to a long-term inflation problem. Because long-run inflation is driven by money growth, and given our belief that the Fed will maintain its aversion to accelerating inflation, our assessment is that inflation will not be a major problem in the foreseeable future, higher energy or not.

Figure 3: Actual & Expected Inflation



"DESPITE SUBSTANTIALLY HIGHER OIL PRICES, LONG-TERM INFLATION EXPECTATIONS HAVE BEEN RELATIVELY STABLE"

Sources: Haver Analytics, Bloomberg, Bureau of Labor Statistics, Stairway Partners

Notes: Monthly data through 4/30/2006. Inflation expectations are 10-year Treasury note yields less 10-year TIPS yields. Actual inflation is the year-over-year change in the Consumer Price Index.

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy	Comment
Equities			small under	
US	6.0%	8.4%	neutral	Exposure equal to normal portfolio weighting
Non-US Developed			small under	Remains unattractive relative to US market
Eurozone	2.7%	7.0%		
Japan	-7.9%	4.4%		
UK	6.5%	8.3%		
Emerging	2.3%	11.6%	under	Asset class inadequately pricing risk
Fixed Income				
US Treasury Bonds			neutral	Sector is fairly priced
2-Year	5.1%	4.8%		
5-Year	5.2%	5.0%		
10-Year	5.2%	5.2%		
30-Year	5.0%	5.4%		
US Municipal Bonds			neutral	Sector is fairly priced
2-Year	3.6%	3.4%		
5-Year	3.9%	3.6%		
10-Year	4.5%	3.9%		
30-Year	7.5%	4.4%		
US High Yield	5.1%	6.8%	under	Spreads over US Treasuries remain too tight
Non-US Government Bonds			under	Yields generally insufficient compensation for risk
Euro 10-Year	2.8%	4.5%		
Japan 10-Year	0.9%	2.1%		
UK 10-Year	3.6%	5.0%		
Emerging Markets Debt	4.7%	7.1%	under	Spreads over US Treasuries remain too tight
Cash	4.6%	---	over	Allocation comes from overpriced asset classes

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-3.3%	-0.6%	-0.5%	Close to fair value
Japanese yen	3.5%	-4.4%	4.5%	Yen is slightly attractive
UK pound	-4.6%	1.9%	-1.0%	Close to fair value

Notes: **As of: 5/31/2006**

The expected return is our estimate of the annualized return likely to be generated over a 3-year horizon.
The expected returns are expressed in local currencies (e.g., Japanese equity return is stated in yen terms).
The hurdle rate represents the annualized return that an asset needs to generate in order to cover its risk.
Equity Return with Currency (in Currencies section) is the annual return we would expect a US dollar investor to earn from holding foreign equity markets.