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MONTHLY

VOLUME 6, ISSUE 9 SEPTEMBER 2009

PRICE STABILITY & THE FED

Introduction

There is a vigorous debate going on about the outlook for price stability in the United States. On one side, deflation is feared by those who believe the economy will continue to suffer from weak aggregate demand putting downward pressure on prices. On the other side, there are those who believe that the current high level of fiscal and monetary stimulus will be left in place too long, causing inflation down the road. This *Monthly* will help frame this debate by examining the role of the Federal Reserve (The Fed) in fostering price stability during these uncertain economic times.

Measuring Inflation

The Consumer Price Index (CPI) is the most widely followed measure of overall prices. It is unique in that many cost-of-living adjustments are based on CPI data. It is also used to adjust income accretion on inflation linked bonds issued by the US Treasury.

Another important measure of inflation is the Personal Consumption Expenditure Price Index (PCE). The PCE is important because it is the measure of inflation most often cited by the Fed in communications pertaining to monetary policy.

CPI and PCE are similar in many ways and have exhibited a high degree of correlation through time (see Figure 1). This is not surprising since the two series are constructed using much of the same underlying survey data. However, differences in the respective weights assigned to this data often lead to deviations in the reported values. Most of these deviations tend to be short term in nature and converge over time.

PCE tends to be lower than CPI over time because PCE is constructed in a manner that better reflects actual

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CURRENT TOPIC

Price Stability

- *Introduction*
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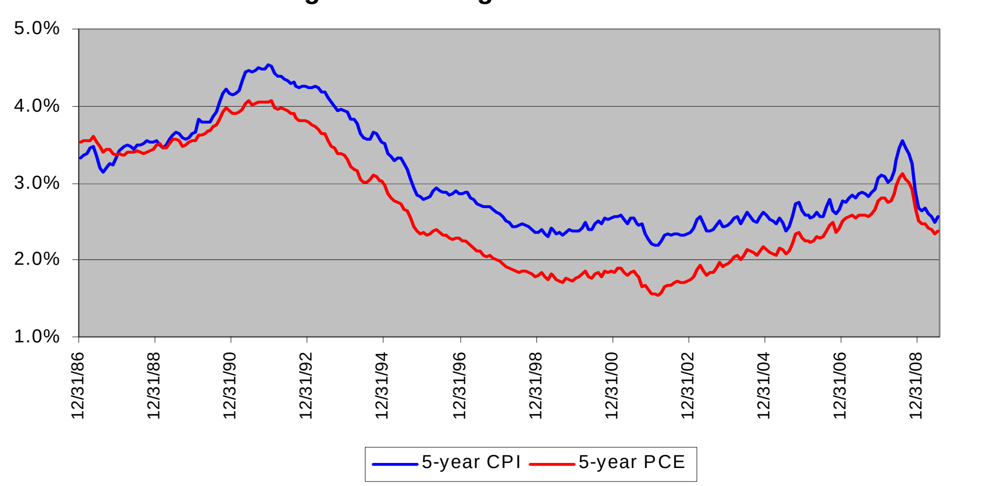
Strategy

- *There were no strategy changes in client portfolios during the month of August*
- *Portfolio strategies remain overweight developed equity markets and high yield bonds*

"ALTHOUGH THE FED DOES NOT HAVE AN EXPLICIT INFLATION TARGET, THEY HAVE OFTEN INDICATED A PREFERENCE FOR PCE INFLATION OF AROUND 2% OVER TIME"

Figure 1: Long-Term Inflation



Sources: Bureau of Labor Statistics, Bureau of Economic Analysis Note: annualized 5-yr rolling inflation

PRICE STABILITY & THE FED - CONT'D

patterns in consumer behavior. This is because the methodology used to calculate PCE better captures substitution, where cheaper goods will be consumed in place of more expensive goods. As an example, if beef becomes unusually high in price, consumers will likely substitute pork as a more affordable alternative.

The Fed and Inflation

As legislated by congress, the Fed's monetary policy objectives are to promote price stability and maximum employment. Although the Federal Reserve Board does not have an explicit inflation target, they have expressed a preference for PCE inflation of around 2%.

The Fed monitors a broad range of indicators in an effort to maintain their desired balance between full employment and inflation. We believe that two of the most important economic indicators they use are the unemployment rate and the capacity utilization rate. These measures are useful in gauging the slack in the economy, often referred to as the output gap.

The current recession has brought about a historically high level of unemployment (9.4%) and low level of capacity utilization (68.5%), which can be seen in Figure 2. We believe that this slack will need to be reduced before inflation will become a threat to the US economy.

Some market participants are fearful that the Fed will be too slow to reduce the level of monetary stimulus as the economy recovers, leading to higher inflation at some point in the future. Although this outcome is a possibility, we believe that the Fed will remove monetary stimulus when appropriate. Supporting our belief is the action taken when Ben Bernanke became Chairman of the Fed in 2006. At that time the Fed was in the midst of a tightening cycle that had taken the Fed Funds rate from 1% to 4 ½%. Despite criticism from many economists, the Fed, under Bernanke's leadership, showed its inflation fighting resolve by continuing to raise the Fed Funds rate to 5 ¼%.

Deflation

A more immediate fear for some market participants is the fear of deflation. They believe that there are com-

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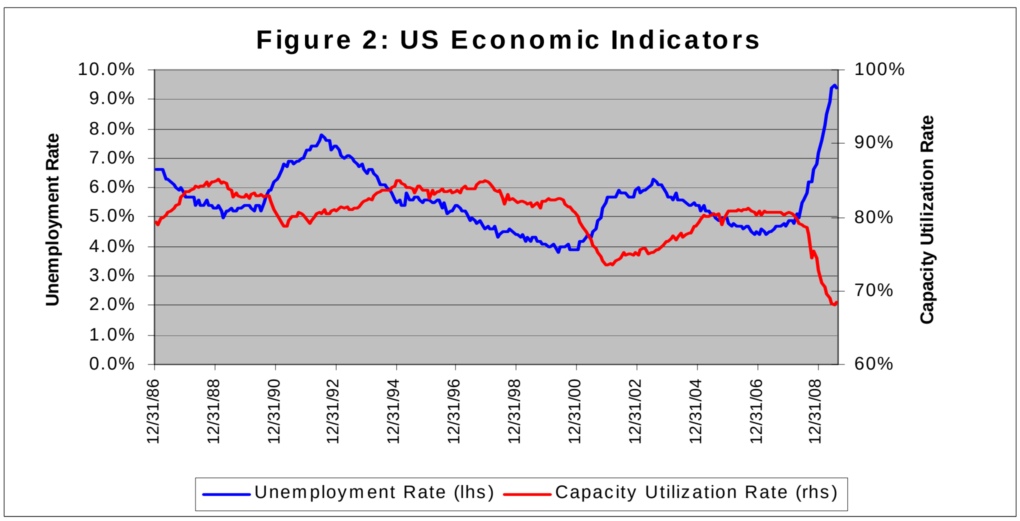
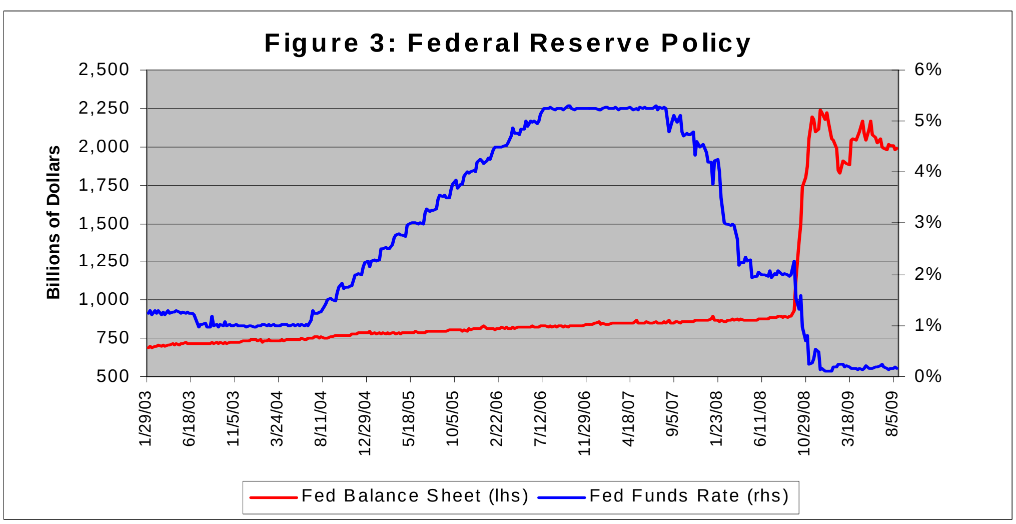




"THE FED HAS BEEN FORCEFUL IN ADDRESSING THE SIGNIFICANT ECONOMIC WEAKNESS BY REDUCING THE FED FUNDS RATE TO NEAR ZERO AND BY EXPANDING THEIR BALANCE SHEET "

Sources: US Federal Reserve, Bureau of Labor Statistics

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.

pelling similarities between the United States today and either Japan's lost decade of the 1990s or the great depression of the 1930s.

After the *bubble burst* in Japan in 1989, the Bank of Japan was seen as being too slow in reacting to the unfolding crisis. They were criticized for not providing monetary stimulus soon enough, and not restructuring the Japanese banking system. During the US depression of the 1930s, it is now believed that the Fed's monetary policy was restrictive and a significant contributor to the protracted economic weakness that persisted for more than a decade.

Chairman Bernanke has published considerable research on the great depression and has also commented frequently on the Japan experience. Under his leadership, the Fed has taken unprecedented actions to avoid these same problems again. As Figure 3 shows, the Fed has been forceful in addressing the significant economic weakness by reducing the Fed Funds rate to near zero and by expanding their balance sheet to alleviate stress in the financial system.

Inflation Expectations

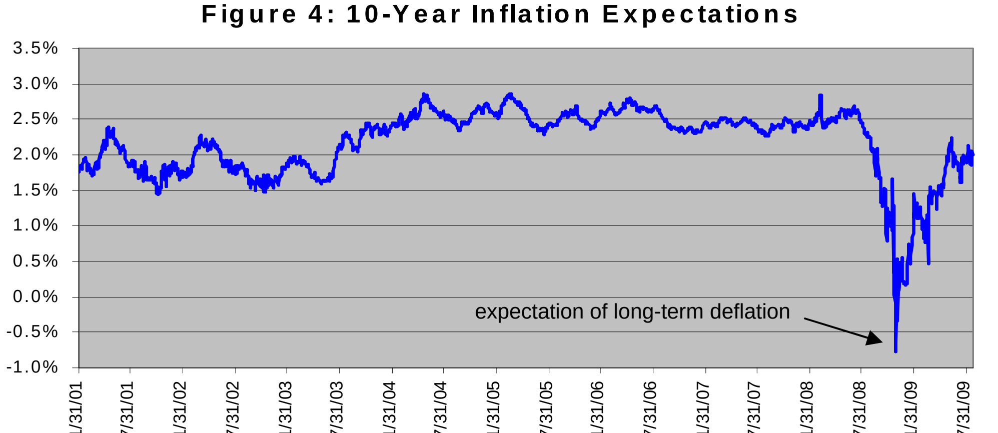
Many times financial markets anticipate changes in economic fundamentals. A market indicator that we monitor is the difference in yield between 10-year US Treasury notes and 10-year Treasury Inflation Protected Securities (TIPS). This difference in yield, is reported daily on our website as inflation expectations, and represents the level of inflation that is priced into the market for the next ten years.

As Figure 4 shows, near the end of 2008, this indicator revealed expectations of long-term deflation even worse than was experienced during Japan's lost decade. After fiscal and monetary stimulus were aggressively implemented, fears of another great depression receded and inflation expectations moved back to more normal levels. We believe this normalization supports the view that the Fed will continue to meet its objective of long-term price stability.

Conclusion

There is considerable debate over whether we should be more concerned with inflation or deflation. Both are possibilities and both are risks that we monitor closely. It is our belief that the Federal Reserve, in addition to the Federal Government, have provided ample stimulus to prevent persistent deflation from being a problem. It is also our belief that the Fed, will act responsibly to remove stimulus when it is no longer needed, and remain vigilant in preventing inflation from becoming a problem.

Figure 4: 10-Year Inflation Expectations



Sources: Barclays, Stairway Partner Note: 10-year US Treasury note yields minus 10-year TIPS

"Near the end of 2008 this indicator revealed expectations of long-term deflation . . . after fiscal and monetary stimulus were aggressively implemented, inflation expectations moved back to more normal levels"

Strategy

Asset Class	Expected Return	Hurdle Return	Strategy Exposure	Comment
Equities				
US	18.8%	5.9%	over	Exposure above benchmark weight due to attractive pricing
Non-US Developed			over	Asset class remains attractive despite recent rally
Eurozone	22.0%	5.8%		
Japan	12.9%	4.4%		
UK	18.2%	6.1%		
Emerging	9.2%	10.3%	neutral	Asset class is close to fair value
Fixed Income				
US Treasury Bonds			under	Treasuries expensive, but non-Treasury sectors are more attractive
2-Year	0.8%	2.8%		
5-Year	0.8%	3.6%		
10-Year	1.3%	4.3%		
30-Year	0.7%	4.8%		
US Municipal Bonds			under	In most maturities, municipal bonds are modestly overpriced
2-Year	1.0%	2.2%		
5-Year	1.2%	2.8%		
10-Year	2.5%	3.5%		
30-Year	8.6%	4.5%		
US High Yield	4.4%	4.3%	over	Sector is fair and attractive relative to emerging debt
Non-US Government Bonds			under	Yields remain below fair levels
Euro 10-Year	1.3%	4.1%		
Japan 10-Year	-0.4%	1.9%		
UK 10-Year	1.0%	4.5%		
Emerging Markets Debt	3.7%	4.6%	under	Other asset classes offer better value
Cash	2.6%	---	minimal	

Currencies	Expected FX Change	Equity Return with Currency	10-Year Bond Return with Currency	
Euro	-8.4%	13.6%	-7.1%	Euro is moderately overpriced
Japanese yen	-2.7%	10.2%	-3.1%	Yen is near fair value
UK pound	-1.4%	16.8%	-0.4%	Pound is near fair value

Notes: **As of: August 31, 2009**

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.