



GHP Investment Advisors, Inc.

Quarterly NEWS

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by Brian J. Friedman, CFA

Is Inflation Around the Corner?

Those of you who took an economics class in college probably remember your professor mentioning that inflation is caused by “too much money chasing too few goods.” Another maxim from the Nobel Prize winning economist Milton Friedman is that “inflation is always and everywhere a monetary phenomenon.” Some of the more interested students probably remember that the job of the Federal Reserve is to help regulate the “money supply.”

If our analysis stops here we might be alarmed by the very large quantities of money the Federal Reserve is pushing into the U.S. financial system. The logic is pretty straightforward. If the Federal Reserve controls the money supply and the money supply is growing rapidly, then inflation must be around the corner. Since the production of goods and services in the economy is declining and the money supply is increasing we must be in an environment of “too much money chasing too few goods.”

While this analysis may ultimately prove correct, it misses a couple of very important factors. These factors were mentioned in that same economics class, but most of us were already sleeping through the professor’s monotone lectures. The first concept is called the money multiplier. In fact, the Federal Reserve does not create money in our economy. The Fed merely influences or incentivizes banks to create money. Banks play this unique role each time they lend or relend a dollar.

In simplified form, the process basically works like this: A bank lends a dollar to a customer. That customer keeps the loan proceeds on deposit with the bank while the money is spent. The bank will then relend the unspent cash yet again. The second loan recipient will leave some of his cash in the bank and the process continues for several more rounds. Of course, the process is even larger because the money paid out to vendors is also deposited in the banking system to be used for further lending.

Given the capital requirements of the banking system you might keep in mind a rough number of 10x as the money multiplier effect when banks are actively growing their loan portfolios. Easy money during the boom period from 2003 through 2007 caused inflation to accelerate (particularly real estate and commodity prices), but now the multiplier is working in reverse as credit contracts.

Bank credit is the ultimate source of money in the economy. The Federal Reserve uses its policy tools to influence bank lending. In normal times the Fed merely needs to add or subtract cash reserves to the banks’ balance sheets and let the money multiplier work its magic. At present, the Fed is pushing cash



into the banks in an attempt to counteract credit retrenchment. Despite these efforts, however, lending continues to decline (see Chart 1). As long as credit contracts, we do not need to be too worried about “too much money chasing too few goods.” In fact, we need to be worried about the opposite: deflation (particularly for assets like houses and cars).

Money is Slowing Down

Another important concept is called the “velocity of money.” You might think of this as how many times a dollar bill changes hands during the year. If the same dollar is used for a greater number of transactions, then velocity has increased. Conversely, if the number of transactions for the same dollar declines, then so does velocity. Velocity slowed during this credit crunch as financial institutions, corporations, and individuals hoarded cash. Slowing velocity combined with less credit indicates that the broader money supply is contracting, despite the expansion in the Federal Reserve’s balance sheet.

One of the ways we can see hoarding behavior is the sharp increase in personal savings. On average, American households gradually reduced their savings over the past several decades and started living on larger credit balances.¹ The sharp reversal in this long-term trend can be seen in Chart 2. After reaching a low of -2.7% in 2005 the U.S. savings rate spiked to 6.9% in May, its highest level since 1993. The Fed pushed money into the system to counteract this hoarding behavior and prevent a complete collapse of liquidity in the economy.

So far, the Federal Reserve’s efforts to stabilize the financial system have worked. Although the banks are now unlikely to collapse, credit is still shrinking. Loan losses are likely to persist well into 2010, preventing growth in new originations. While existing problems with residential mortgage loans are now familiar to everyone, commercial real estate loans, credit cards, and business loans are experiencing widening defaults. The Fed’s actions, combined with recent recapitalization from the government and private investors, should prevent further meltdown. Banks, however, are unlikely to resume lending in significant volume for quite some time.

As long as bank lending is constrained so too is the broader money supply. In this environment the Fed is rightly focused on financial stability rather than inflation. As defaults recede the Fed will then need to reverse many of its crisis driven policies. If the Fed moves too slowly when lending recovers, then inflation could become a problem.

¹ This trend is overstated in the savings statistics produced by the Federal Government in several ways. An important example is the government’s classification of education expenditures as consumption rather than investment. This has had the effect of reducing the personal savings rate as more people attend college and pay higher tuition. If we adjust for the general underestimation of savings, then the sharp increase in the personal savings rate during this credit crunch is even more dramatic.



The Risk of 1970's "Stagflation" is Low

The Federal Reserve essentially made the mistake outlined above between 2003 and 2005. As economic recovery took hold in the aftermath of the technology bust, September 11th terrorist attacks and corporate accounting scandals, the Fed raised interest rates too slowly. Confidence in the financial system was shaky and they did not want investors to lose faith prematurely after such a dramatic episode. Despite this policy mistake, however, inflation peaked at an annualized rate of 5.6% in July 2008. This was a far cry from the 1970's peak of 14.8%. Moreover, the "core" inflation rate (excluding food and energy) peaked at 2.9% in September 2006 vs. 13.6% during the 70's.

The inflation we experienced between 2003 and 2008 was more muted for two primary reasons. First, the U.S. economy is still benefitting from technology driven productivity growth. Before we compare the present situation with the 1970's it is important to remember that productivity growth in the U.S. economy was already slowing by the late 1960's and inflation was accelerating. The core rate of inflation already averaged more than 6% in 1968 and 1969, well before the period we commonly associate with "stagflation" (i.e., slow economic growth combined with high inflation). The current economic backdrop of higher productivity and modest inflation is quite different.

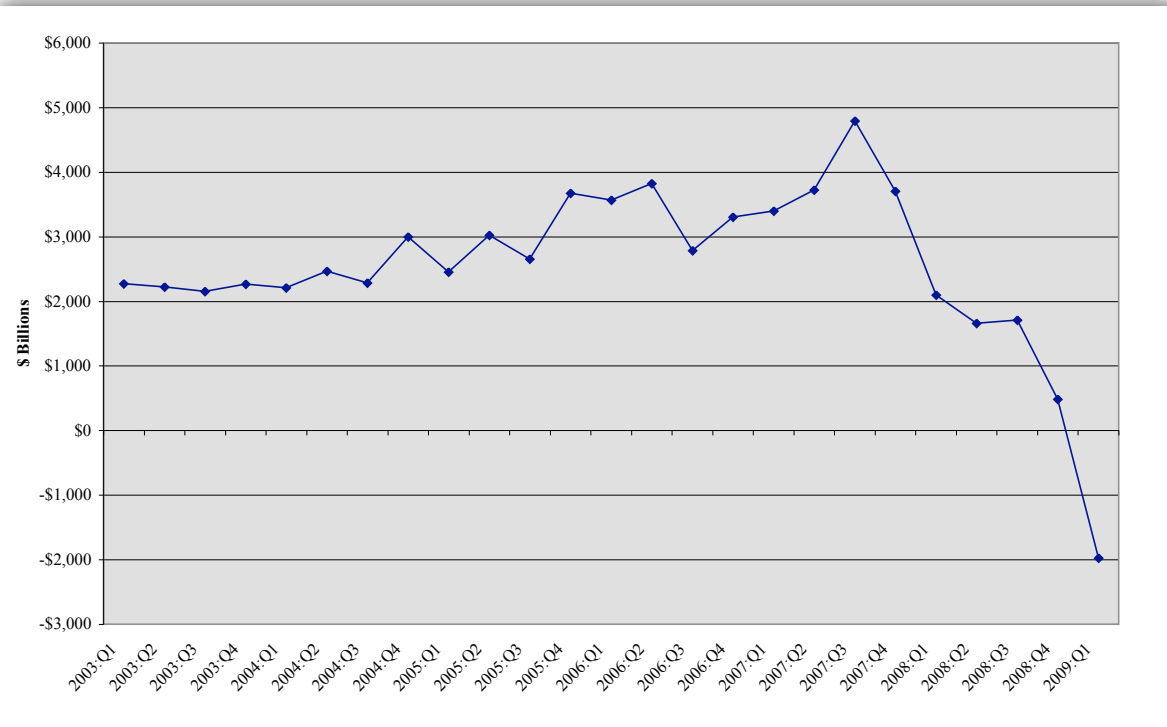
Second, inflation in recent years has largely been concentrated in asset bubbles. Rather than experience broad increases in consumer prices, recent episodes of inflation have shown up first in stock prices in the 1990's followed by housing and commodity prices more recently. Each of these asset bubbles was followed by a very sharp disinflationary period once they popped. Given the productivity trends outlined above, inflation (if the Fed makes the same mistake again) will likely show up in another asset bubble as capital is channeled to the next productivity enhancing innovation.²

Rising inflation is not a foregone conclusion despite the Fed's recent policies. Rising government spending and debt poses another potential inflation threat, if the Federal Reserve decides to "monetize" that debt through ongoing purchases. Over the next several quarters credit contraction is still the main problem, but the Fed will need to be cognizant of the risks of reversing course too slowly. As long as Fed policy makers remain independent of the Federal Government (a likely outcome given the consensus regarding central bank independence in the United States) we believe they will remain focused on their primary mission of "price stability" over the long run. Some mistakes will undoubtedly occur during this unwinding process, but we think a 1970's style stagflation is an unlikely outcome.

² The Internet fueled the technology boom of the 1990's while securitized mortgages led to the housing boom and bust. Arguably, industrial development in emerging market economies such as China and India spurred investments in commodity sectors such as oil, metals and agricultural goods. Productive investments are a natural draw for excessive money in the economy because profits are high in the early years, but we soon run into a phenomenon of "too much money chasing the same opportunities." The 1970's witnessed a relative lack of productive investments combined with a surplus of money. Hence, a greater proportion of the inflation at that time showed up more broadly in consumer prices.

Chart 1

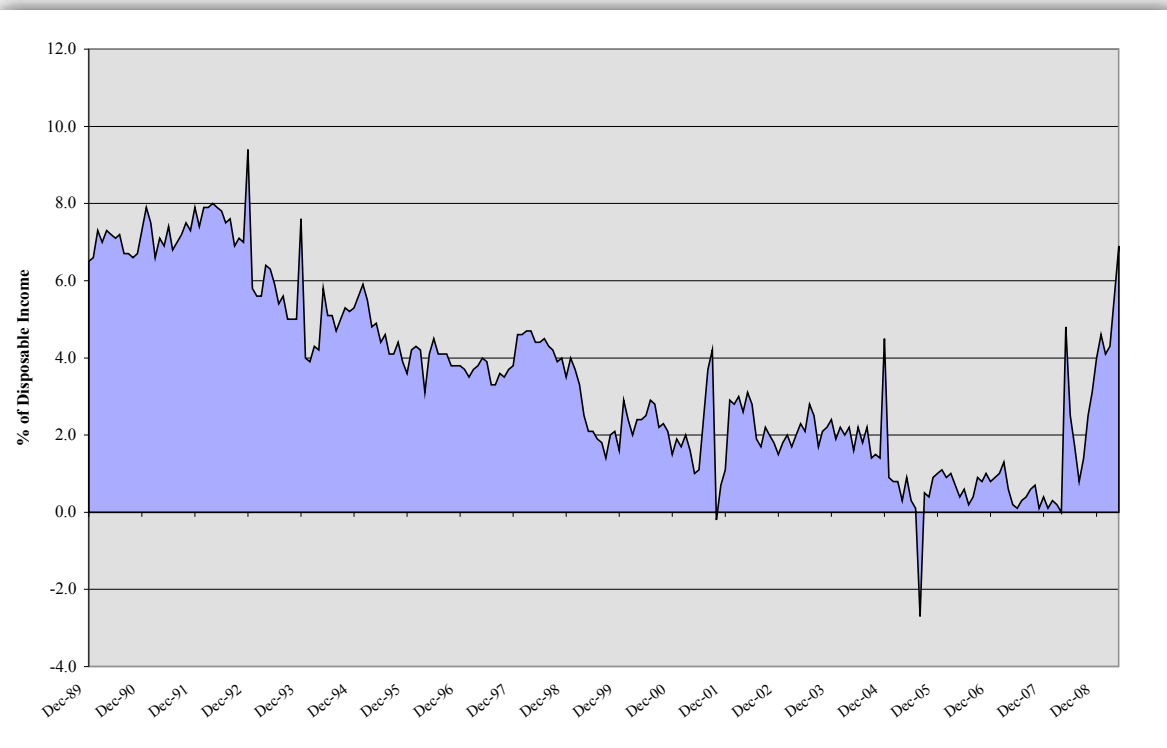
Private Sector Borrowing in the United States



Source: The Federal Reserve Board of Governors, "Flow of Funds Accounts." 6-11-09

Chart 2

United States Personal Savings Rate



Source: Bloomberg L.P. 7-3-09



Market Summary

Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2009:Q2	P/E Benchmark	Over/Under Valuation	Price/Book Value 2009:Q2	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	12.8	27.0	-52.6%	2.8	5.7	-51.4%
Large-Cap Value Stocks	17.3	20.2	-14.4%	1.5	2.5	-39.6%
Mid-Cap Growth Stocks	12.9	24.8	-47.9%	2.1	4.5	-53.3%
Mid-Cap Value Stocks	14.8	19.1	-22.7%	1.3	2.2	-39.5%
Small-Cap Growth Stocks	15.7	23.2	-32.3%	1.7	3.5	-51.7%
Small-Cap Value Stocks	23.3	18.2	28.1%	1.2	2.1	-44.3%

*Please note that the P/E data reported above are based on “as reported” earnings information rather than “operating” earnings. “As reported” earnings include one time write-offs whereas “operating” earnings reflect the profitability of a company as a going concern. We believe P/E’s based on operating earnings are a better long-term valuation indicator, but Standard and Poor’s does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and “as reported” earnings can be significantly lower than “operating” earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using “operating” earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 6/30/09.

Returns by Index

Index	2009:Q2	YTD
DJIA Total Return*	11.95%	-1.97%
NASDAQ*	20.33%	16.98%
S&P 500*	15.93%	3.16%
S&P 500/Citigroup Value	17.51%	-1.41%
S&P 500/Citigroup Growth	14.60%	7.52%
S&P MidCap 400/Citigroup Value	18.78%	4.40%
S&P MidCap 400/Citigroup Growth	18.72%	12.67%
S&P SmallCap 600/Citigroup Value	20.60%	-2.04%
S&P SmallCap 600/Citigroup Growth	21.51%	3.47%

DJIA & NASDAQ: Bloomberg L.P. as of 7/1/09.

*S&P Returns: Standard & Poors (July 1, 2009)
Standard & Poor’s Reports June 2009 Index
Returns. Press Release.*

**Dividends Reinvested.*

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GHP Investment Advisors, Inc.
Registered Investment Advisor

1670 Broadway, Suite 3000
Denver, Colorado 80202

P 303.831.5000
F 303.831.5082
Invest@GHPIA.com
www.GHPIA.com

Brian J. Friedman, CFA
President

Robert W. Hochstadt, CPA/PFS
Senior Principal

Steven I. Levey, CPA/PFS
Senior Principal

David J. May
Analyst

Carin D. Wagner, CFP®
Financial Planning Manager

Sommer C. Vincent
Client Relations Manager

Mike Sullivan, CFP®
Financial Planning Assistant



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