



April, 2008

Dear Gamble Jones Client:

At least the first half of the year hasn't lacked for excitement. While the credit crunch that we referenced in last quarter's letter has undoubtedly provided some with a few Maalox moments along the way, it appears that the worst of that crisis is behind us. To be sure, the credit markets are still tight and there are still likely to be additional bumps along the road ahead. However, the flood of panic that had served to paralyze the credit markets has largely receded and some sense of normalcy has returned. The economy has also proved to be resilient, avoiding recessionary territory to date. Even though we are not out of the woods yet and a recession is still possible, we believe that we will be able to avoid the deep recession that so many were calling for just a few months ago. With that in mind, we will follow the Federal Reserve's lead and focus on another issue at hand – rising inflation.

The Federal Reserve is charged with the dual mandate of promoting both high employment and price stability. To put it another way, the Fed's goals are to help keep the economy growing and inflation under control. For much of the past year, the Fed aggressively cut interest rates in an effort to restore order to the credit markets and prevent the economy from tumbling into a severe recession. However, an excessively loose monetary policy can lead to too many dollars chasing too few goods in the marketplace, ultimately resulting in a sharp rise in inflation. With this in mind, at its most recent meeting the Fed decided to halt its string of rate cuts. Its rationale for the pause is that the credit markets and the economy have stabilized to the point that further aggressive rate cutting is no longer necessary and that further rate cuts could lead to additional inflationary pressure. Inflation, as measured by the Consumer Price Index, currently stands above 4% on a year over year basis. Even after stripping out the historically volatile food and energy components, as many are wont to do, so-called core inflation has for the last few years been consistently running just above the 2% upper limit of the Fed's target range.

Commodity prices have been leading the inflationary charge. Prices for energy, metals and foodstuffs have all soared to new heights. The main reason for this run-up has been a surge in demand for these commodities from rapidly growing emerging markets such as China and India. In short, industrialized nations such as the U.S. are now having to share more of the world's commodities with these developing nations. This growth in demand has not been met equally by an increase in supply, and the natural result has been a jump in prices. Other factors are also contributing to the rise in commodity prices. Most commodities are priced in U.S. dollars, so the decline in the dollar has made commodities cheaper for foreign buyers. This has served to increase foreign demand for commodities and drive up prices. In addition, speculators have also contributed to a portion of the run-up by pouring money into commodities futures, index funds and ETFs, likely causing the prices for some commodities to at least temporarily rise above their fundamental supply and demand values.

The rising cost of commodities has of course been headlined by the spike in the price of oil. At over \$140 a barrel as this letter is written, the price of oil has more than quadrupled since 2003 and has doubled since just Labor Day of 2007. While the rapid advance in oil prices has certainly been dramatic, it is not likely to be as damaging as the spike that occurred in the mid-1970s. The U.S. is now far more energy efficient than it was in the '70s, requiring only about half as much energy to produce a unit of economic output as then. Even so, companies such as the airlines and carmakers, for which oil is a major cost component, have been hit hard by the run-up. And with the average price of gasoline in the U.S. recently topping \$4 a gallon for the first time, consumers have been feeling significant pain as well.

Another source of inflation that has been flying somewhat under the radar is the increase in the cost of imported goods. The U.S. had until recently enjoyed decades of importing goods ever more cheaply from various low-wage emerging markets, which had helped to keep domestic inflation in check. However, a number of these developing nations have started to experience a surge in inflation to double-digit levels due to their rapid growth. This has forced many of them to begin passing along these rising costs to customers, of which the U.S. is the largest. Given that emerging markets now produce nearly half of all American imports, this is an important development. On top of that, a reduction in purchasing power resulting from the declining dollar is adding even more to the rising cost of imported goods. As a result, the core import price index is currently up more than 6% year over year, the largest rise in the twenty years during which it has been measured.

As inflation has climbed over the last few years, there has been growing concern that the U.S. could eventually become mired in an economic environment reminiscent of that of the 1970s when inflation reached double-digit levels. Ultimately, the key to avoiding an unpleasant repeat of history will be to keep inflation expectations in check. This is critical because once it is presumed that inflation will reach an elevated level for an extended period of time, then such expectations are likely to become embedded in everyday behavior as wages and prices are set. Companies that expect costs to remain high for a protracted stretch will attempt to pass those expenses on to consumers in the form of higher prices. Consumers facing higher costs will then demand higher wages in order to be able to pay for the price increases, setting off a "wage-price" spiral such as that which occurred in the '70s.

While inflation expectations have recently crept up on the back of the spike in oil prices, they are still far below the levels that induced the inflationary spiral of the '70s, and it is unlikely that such a spiral will take hold this time around. The central reason for this is that due to the softening job market, it has become increasingly difficult for workers to command higher wages. Without a large increase in wages, high inflation expectations are not likely to become embedded in the economy. Most businesses will not be able to pass along large price hikes, because without higher wages consumers will not have the means to pay for them. In addition, wages serve as the largest expense for most companies, so with that cost in check it puts less pressure on businesses to even attempt to pass along higher energy costs through price hikes.

Inflation has been described as paying fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair. Although never pleasant, inflation is generally tolerable so long as it is not allowed to careen out of control. While inflation has crept up over the last few years, it is still far from the double-digit levels experienced in the '70s. We fully expect the current economic slowdown to help keep inflation in check by curbing demand for goods

and services. Should this scenario fail to unfold, the Federal Reserve stands poised to raise interest rates to help keep inflation under wraps.

Given that we will likely be faced with less than ideal economic conditions for the next few quarters, it is as important as ever to be invested in quality companies with strong balance sheets that are well equipped to weather such an environment. While not immune to temporary pullbacks, positions in such companies have historically proven to be resilient over the long term. Periods of unrest often present opportunities to invest in quality names at exceptional values. We expect to receive such opportunities in the coming months and are prepared to capitalize on them as they arise.

Sincerely,

Gamble Jones Investment Counsel