

# Actions Have Consequences

BY ALFRED A. LAGAN, CFA, CHAIRMAN



FEBRUARY 11TH, 2011

Numerous warnings about inflation have been issued lately. They follow a string of well publicized price increases on a broad array of agricultural and industrial commodities. Consumer prices have also risen, notably for gasoline. Further indications of inflation can be seen in an index of import prices and in cost pressures at earlier stages of production. Import prices are heavily influenced by the sharp rise in the price of oil, but even non-petroleum imports have increased lately at a more rapid pace than the consumer price index. Corporations have been reluctant to pass along cost increases on raw materials due to intense competition and fear of loss of market share. As a result these cost pressures have not seeped into the general price level. The consumer price index increased only 1.5% last year vs. 2.7% in 2009. The core index has behaved even better, increasing just 0.8% in 2011, substantially below the Fed's preferred target of around 2%.

Viewed in isolation these inflation statistics are not cause for alarm. They came at a time when the economy was slowly turning from its deep recession.

Lately, however, growth has been noticeably stronger and gaining momentum. Real Gross Domestic Product in last year's final quarter increased 3.2%, led by a 4.4% increase in consumer spending. Despite the havoc created by the severe winter, indications are that the labor market is gaining traction. The unemployment rate declined 0.4% in two consecutive months, a very encouraging sign. Improved employment points to a continuation of rising consumption and wages. At 70% of economic output, rising consumption will add meaningfully to economic growth and indirectly support pricing power for consumer goods. Capital spending, too, is strong and getting stronger. The new accelerated depreciation allowance this year and next will be a significant catalyst to business spending, which could see record levels this year. Exports are continuing their robust growth. Overall, the sturdy economic picture is causing economists to raise their estimates of GDP growth for the first quarter and the year.

By any measure the Fed's monetary policy has been extraordinary and unprecedented. The most recent change to the federal



CONGRESS ASSET  
MANAGEMENT COMPANY

2 Seaport Lane • Boston, MA 02210-2001 • 800.542.7888

funds rate, the Fed's chief mechanism for implementing interest rate policy, was a cut of 75 – 100 basis points from 1.0% to a range of zero to 25 basis points on December 16, 2008. This followed a rapid series of cuts which reduced the rate from 4% to 1% within one year. The unprecedented reductions came at a time of grave economic crisis and growing fears of a descent into deflation. With core inflation remaining significantly below the Fed's implicit target of 2% and dissatisfaction with the anemic results of the stimulus the Fed inaugurated its second significant round of "quantitative easing", dubbed "QE-2" by the media, in November 2010. As explained by Chairman Bernanke in a speech in October 2010, the goal of "QE-2" is to push yields on Treasuries and bonds down and produce a surge of investment and consumption expenditures. "QE-2" has created a storm of controversy due to the run-up of government debt, potential negative affects on our currency, and fears of creating a new asset bubble primarily in strong currency nations.

The Fed has been steadfast in its defense of "QE-2" and its zero interest rate policy, and has been more vocal in warning against cutting government spending too soon. The Fed, of course, has access to reams of data and is aware of economic conditions throughout the country and the world. Still, it is evident to a growing number of economists and to the financial markets that the page has been turned on the recession and momentum for further gains is strong. Economic surprises lately have been predominantly positive. Rising confidence in the economic environment among businesses and households will lead to further increases in investment and consumption. Inflation has reached an inflection point, with both core and household measures subject to increasing pressure. Inflation is a lagging indicator and will increase as conditions continue to improve. We believe the Fed will be forced to begin to withdraw accommodation soon, leading to an extended period of higher interest rates.

Investment Policy Committee  
Alfred A. Lagan, CFA, Chairman  
February 11th, 2011



Mr. Lagan founded Congress Asset Management Company in 1985 and is Chairman of the firm. Mr. Lagan is a member of the Investment Oversight Committee and Large Cap Committee and Chair of the Fixed Income Committee. Mr. Lagan also is Vice Chairman of the Board of Directors of Congress Trust, N.A. Prior to starting Congress, Mr. Lagan held senior investment positions at several financial services firms. Most recently he was Senior Vice President, Senior Portfolio Manager, and director of several investment subsidiaries of the Putnam Companies. Mr. Lagan is a CFA charterholder and a member of the Boston Security Analysts Society and the Boston Economics Club. He has an MBA from New York University with distinction and a BA from Iona College.

This information is intended solely to report on investment strategies as reported by Congress Asset Management. Opinions and estimates offered constitute their judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions.

To learn more about Congress Asset Management, please contact us at 800.542.7888 or visit [www.congressasset.com](http://www.congressasset.com)