ALTMAN INVESTMENT MANAGEMENT

ECONOMIC INSIGHTS: INFLATION

AUGUST, 2007

Written By: *Peter J. Altman, President*
Jonathan Felsher, Research Associate

Altman Investment Management
34 Chambers Street, Suite 01
Princeton, NJ 08542
609.252.0048
paltman@altman-investment.com

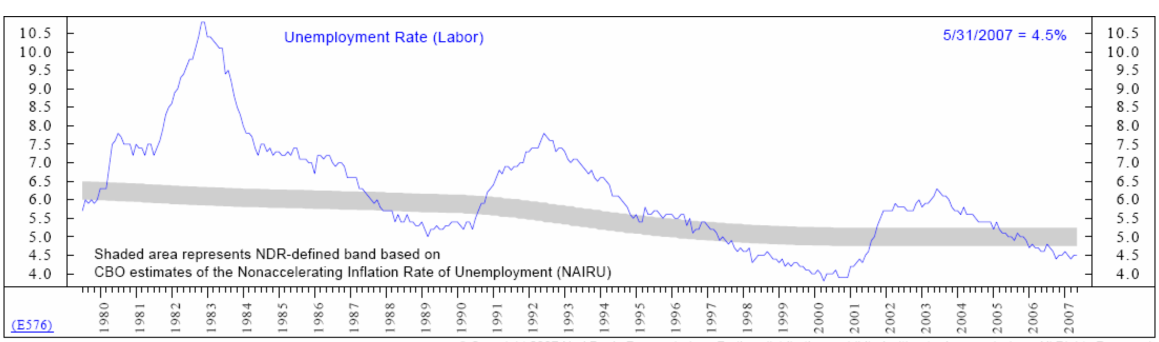
EXECUTIVE SUMMARY:

Currently the U.S. economy is growing at a moderate pace with the preliminary estimate for Gross Domestic Product (GDP) growth in the second quarter at 3.4% (annualized). However, the second quarter GDP growth rate may be misleading because in the past two quarters the economy has shown slower GDP growth, exhibiting only 0.6% growth in the first quarter of 2007 and a 2.9% rate of growth for the full year 2006. Most analysts do not believe that the current GDP 3.4% growth rate is sustainable. Coupled with the moderate pace in growth, the economy is experiencing inflation at the upper end of the Federal Reserve's comfort range, which currently lies at 1% to 2%. In fact, the core Consumer Price Index (CPI less food and energy), grew at 2.2% over the last twelve months. However, the good news is that employment remains strong as the U.S. has been experiencing sustained levels of low unemployment, with the most recent numbers showing 4.6%, as well as continued gains in non-farm payroll employment.

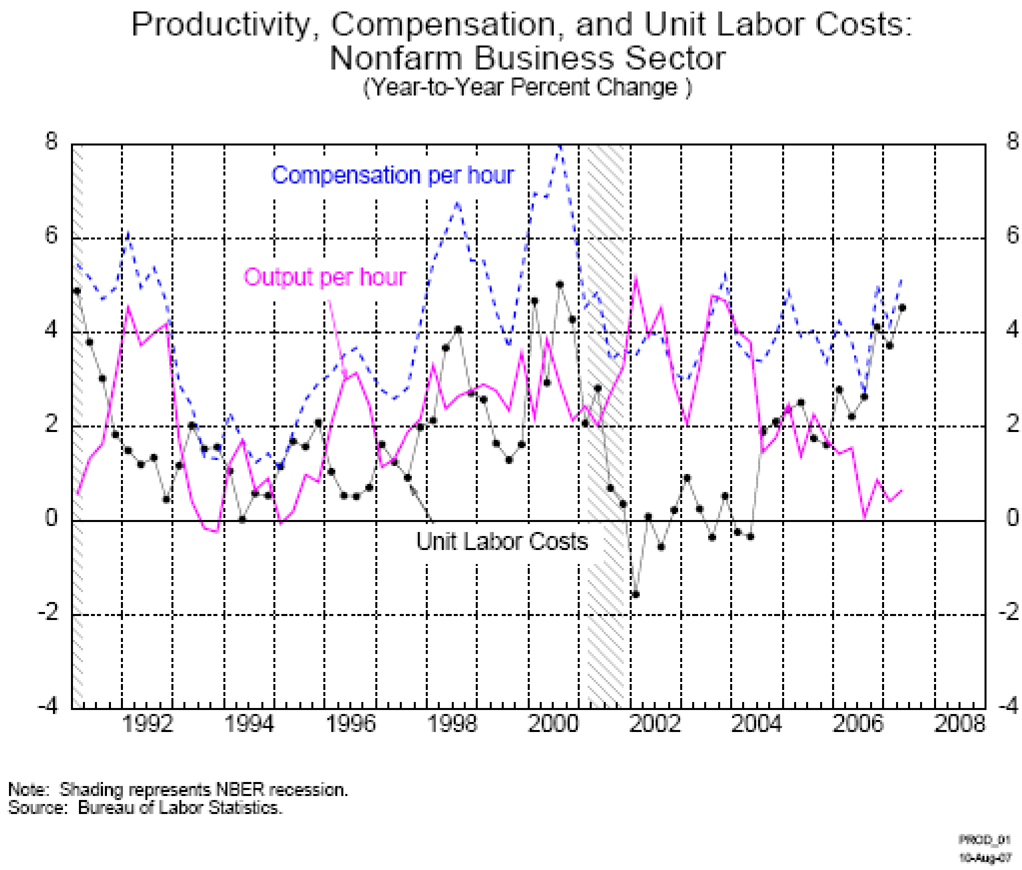
In this paper, we will expand on the numbers provided above. We will also provide some of our own insight on the major issues such as the current housing decline, high energy prices, weakening dollar, strong job market and moderate economic growth. We will explain how each of these issues might affect inflation.

EMPLOYMENT OVERVIEW:

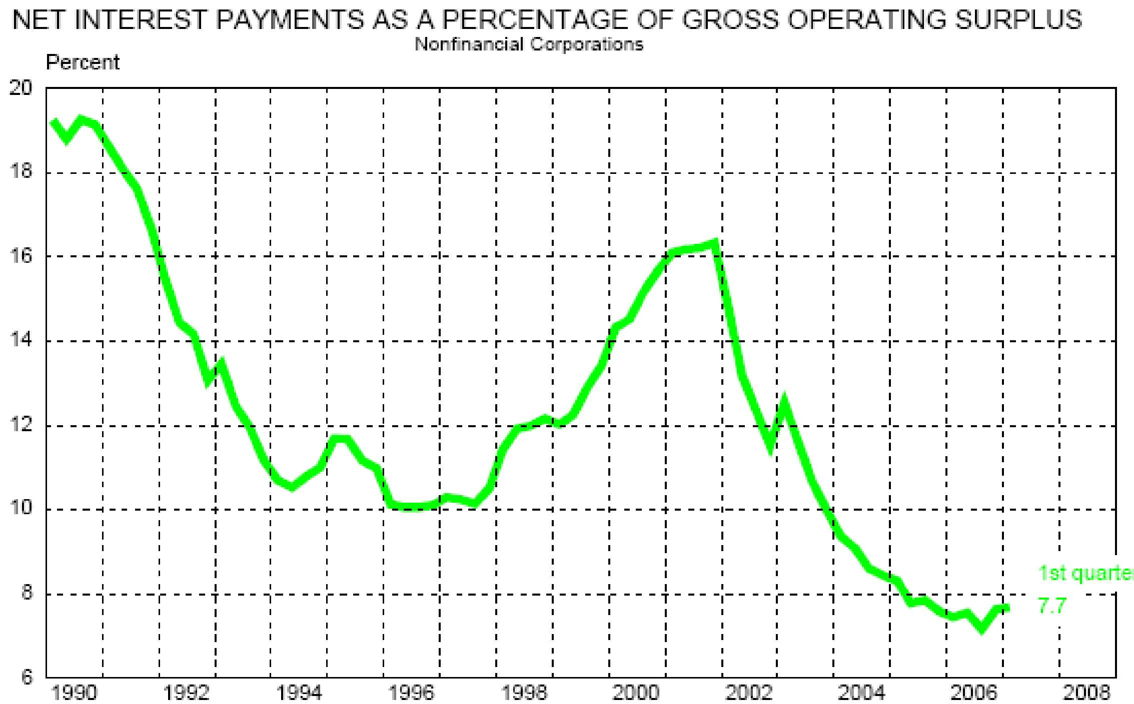
The job market in the United States has been strong for several years and quite stable when compared to the historically less stable job market in this country. This bodes well for continued growth in the economy. The strength has been noted by the fact that the unemployment rate has been at or below 5.0% since June 2005 and gains in non-farm payroll have averaged 176,000 per month since January 2004. While the most recent number for payroll gains was only 92,000 in July, this should not be reason for concern as most businesses are continuing to do well with strong profit growth.



In addition, U.S. businesses have also been experiencing historically high productivity gains over the past 10 years, which has aided growth and curbed inflationary pressures from making their way through the system. The non-farm business sector in the United States has averaged approximately 2.6% output per hour annual growth since the beginning of 1998; however, we have seen a slight slowing in productivity growth in the past two years. In the second quarter of this year, we saw a lower than expected .6% year over year percentage change for non-farm business sector output per hour. This slowing in productivity growth has been offset by strong wage growth, which impacts an increase in inflationary pressures as unit labor costs rise. We have seen hourly compensation rise 5.2% over the past year, comparing the second quarter of last year to the second quarter of this year, which has caused unit labor costs to rise.



Increases in hourly compensation over the years are largely attributed to the strong profit growth and ample liquidity of American businesses. We have seen annual profit growth of close to 15% since 2002. While productivity growth slowed for the year ending in the second quarter of 2007, we can expect it to pick up as businesses do have ample liquidity and are constantly reaping the benefits of increased efficiencies in productivity due to technological innovations. Financial stability for businesses is demonstrated by their high operating surpluses relative to their net interest payments, illustrated in the next graph. Currently, the net interest payments as a percentage of gross operating surplus for businesses are at their lowest levels in over twenty years, supporting the substantial amount of liquidity. Furthermore, we expect high levels of liquidity in the business sector will serve to sustain or exceed the close to 4% hourly compensation growth seen in the non-farm business sector since 2002.



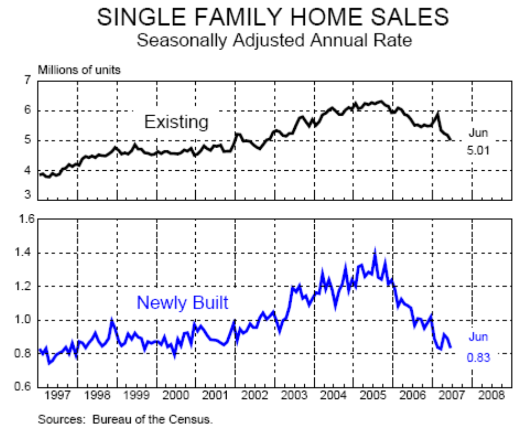
Note: Gross operating surplus is defined as a net operating surplus plus consumption of fixed capital.

Source: Bureau of Economic Analysis.

Since 2002, the average annual increase in unit labor costs has been approximately one and a half percent. Yet, since the second quarter of last year, the increase in unit labor costs has shown a marked increase of 4.5%. Prospectively, we expect unit labor costs to moderate somewhat, especially when the impact of the recent credit crunch is reflected in profits and liquidity. However, as most businesses should be able to weather the impact of the credit situation, the increases in unit labor costs should not be affected dramatically; rather unit labor costs should continue to elevate only slightly over recent levels.

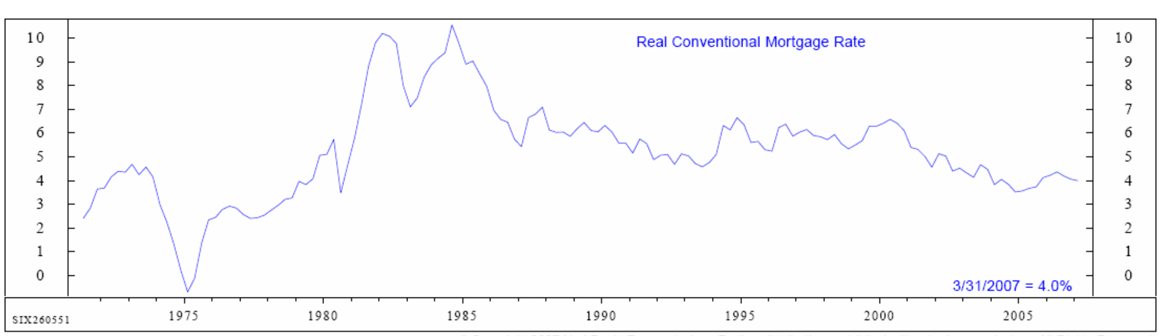
THE SLUMPING HOUSING AND CREDIT MARKET:

Since the end of 2005, the housing market has been weak with existing homes sales – the number of existing homes sold – declining by 18.7%. Furthermore, housing starts have declined 29.1% from June 2005 to date. Such a sharp decline has not been seen since the recession of 1990. However, this current housing decline has not been coupled with a recession. In fact, the U.S. economy has maintained moderate growth spurred by high capital expenditures, stable employment market and strong international growth. Nevertheless, the reason that the economy is not growing at a faster pace is because of the drag caused by the housing slump. Most other factors in the economy currently promote growth.



As we and many other analysts believe, the current fallout from the overexpansion of subprime mortgage lending has precipitated an increase in mortgage foreclosures. This has adversely affected the housing market. Over time, people have demonstrated a prolonged reliance on credit confirmed by our nation's sustained low savings rate, which currently stands at an annual rate of .6% As the Federal Reserve has continued to raise interest rates over the last number of years, borrowers have had difficulty paying their variable interest rate mortgages. Due to this subprime mortgage issue, a lot of mortgage and lending companies have sustained substantial losses. For example, American Home Mortgage has recently filed for Chapter 11 bankruptcy. Responsively, mortgage lending companies' stocks have not recently performed well.

One of the main causes that have driven stock markets lower in the recent weeks has been the fear that the current housing situation will leak into other areas of the economy. However, the current strong employment situation coupled with the low savings rate has counterbalanced the decline and instability in the housing market. Furthermore, if unemployment remains low as it has been and individual earnings continue to increase at a solid pace, as we have been seeing in this expansionary period, then we should see an increase in home sales. The fact that pending home sales for the month of June increased by 5.0%, which was more than analysts had expected, is a beacon of hope indicating future increases in existing home sales. Also, the current Real Conventional Mortgage Rates now compared with historical rates are more accommodative of home buying. Only the subprime market of mortgages, which represents approximately 15% of the mortgage market, is facing difficulties with adjustable rate mortgages. The fact that the subprime mortgage market represents a small portion of the overall mortgage market may mean that the downturn was an overreaction to credit problems in the economy.

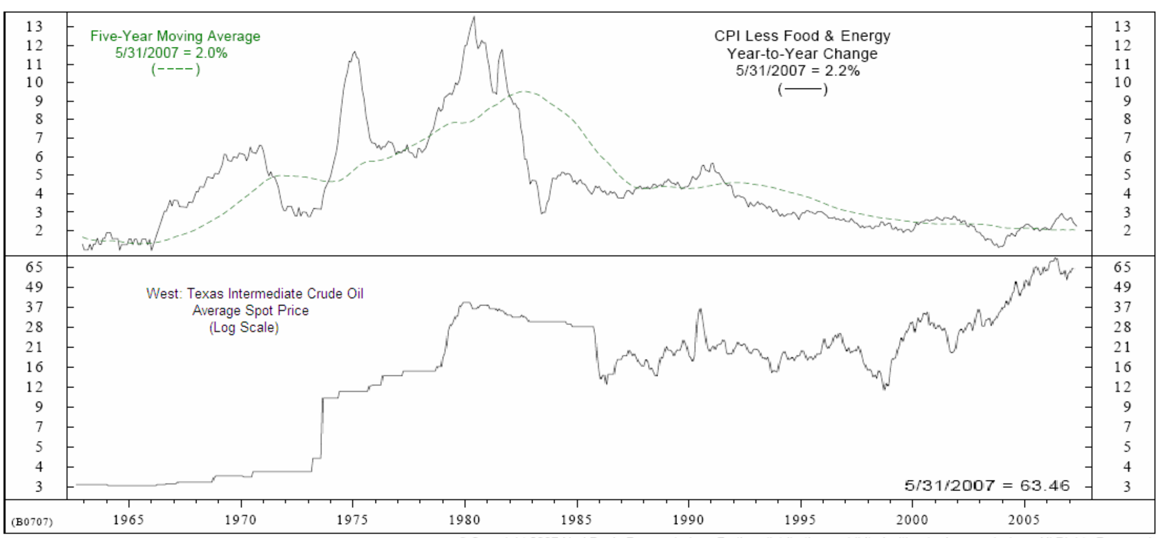


Although there is some indication that we are approaching the trough of the decline in the housing market, we do not believe that the turnaround will occur immediately, as the affects of this decline are widespread. We believe that it will take some time for home sales and home prices to regain more normal trends in late 2008. The buildup of home inventories will hamper new construction as builders work down their inventories before continuing construction.

ENERGY:

Currently we are experiencing historically high energy prices with crude oil having been above fifty dollars per barrel since mid 2004. In the past month, crude oil prices surged to over 70 dollars per barrel. This rise in demand for oil is typical in the summer months. We saw a similar trend last summer when crude prices reached seventy-six dollars per barrel. Despite oil prices holding at historically high levels, it should not elicit concern that it presents inflationary pressure because we have seen these elevated oil prices for quite some time and yet it has not been accompanied by similar high levels of core inflation.

Unfortunately, energy prices are subject to many factors that cannot be controlled such as geopolitical instability. The Middle East, a major American and world supplier of crude oil, is a highly unstable region with continuous disputes and threats of terrorist activity. As this instability persists, the chance of an oil spike is imminent. Many energy analysts believe that a substantial increase in stock prices from current levels is unlikely. At this juncture, we believe that oil prices will tend to stabilize by year end.



INFRASTRUCTURE:

With the recent collapse of the bridge in Minneapolis, there has been a spate of inquiries into bridges and other infrastructure throughout the United States. Most of the findings show that around 27% of infrastructure in the U.S. is structurally deficient. Besides the bridge in Minneapolis, there was also a steam pipe that burst in New York City, emphasizing to the government that infrastructure throughout the United States is in need of maintenance and repair expenditures.

The weakening in infrastructure could mean that the government is going to spend money to fortify bridges and roads. The American Society of Civil Engineers estimates that 1.6 trillion dollars over the next five years is needed to repair the infrastructure in the United States. If the government does spend that much or close to that amount, there will be a huge inflow of money into the economy. This inflow could boost the economy and have far ranging effects such as increased GDP growth, higher demand for blue-collar workers, and increased need for materials such as steel and cement.

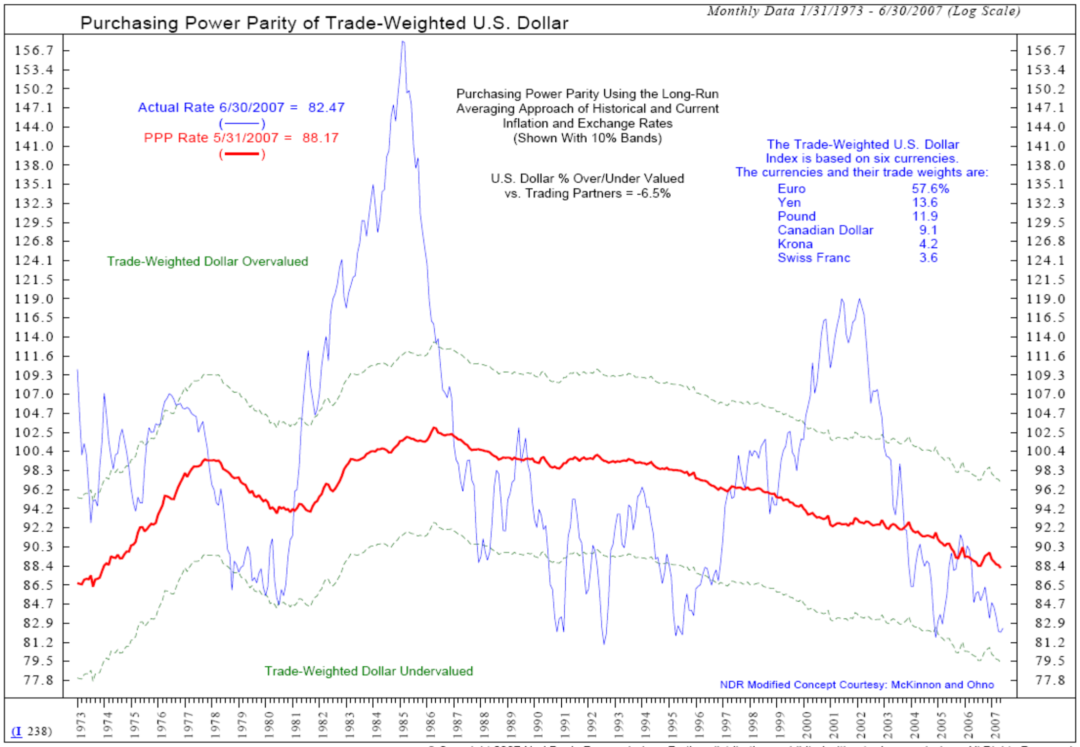
On the other hand, if we see more structural failures like the bridge in Minnesota and the steam pipe in midtown Manhattan, then there may be adverse economic affects. If key highways, such as I-95, were to become impassible at certain junctures, then transportation of goods would not only be delayed but additional transportation costs would have to be absorbed or passed on in the form of increased prices. If these infrastructural transportation failures continue, especially in higher volume areas, then the economic implications would be widespread and there would be a negative effect on prices, inventories, sales, and production.

However, we believe that the bridge collapse in Minneapolis is not a sign of widespread structural failures, because according to engineering reports to Congress, infrastructure deficiencies are not at abnormal levels nor is the percentage of structural deficiencies increasing. Nonetheless, we believe this recent event will impel the government to spend more money on fortifying infrastructure throughout the country. While we think it is unlikely that the government will spend the estimated $1.6 trillion dollars on infrastructure to eliminate all structural deficiencies, it would be reasonable to assume that substantial increases in government spending on infrastructure is likely.

DEPRECIATING U.S. DOLLAR:

Recently we have been experiencing a depreciating dollar compared to many of the other major currencies. As the U.S. inflation rate has outpaced many of the other major country's inflation rates, other currencies have become more desirable than the U.S. dollar. However, the Purchasing Power Parity of trade weighted U.S. Dollar shows that the dollar should be slightly stronger than the exchange rate markets currently indicate. We are beginning to see the dollar rebound slightly against these major currencies, especially the Euro and the British Pound.

Another reason contributing to the depreciating dollar is that many foreign investors have been pulling out of U.S. financial markets because of the fear that the housing slump will affect other areas of the economy and impede growth. This has had the adverse effect on the value of the dollar. However, as investors gain more confidence in the growth prospects in the U.S., we should begin to see the dollar appreciate.



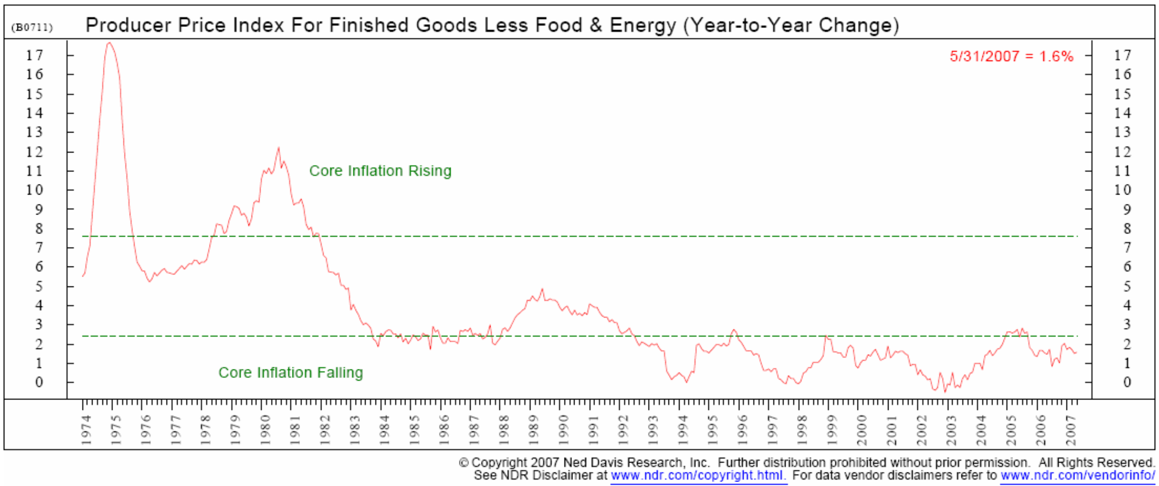
INFLATION EXPECTATIONS AND FED POLICY IMPLICATIONS:

Currently, inflation remains the main concern of the Federal Reserve's FOMC. The most significant inflationary pressure comes from the employment sector of the economy. Unemployment has been very low for a long time and wages have been steadily increasing, which has historically led to higher inflation. However, over the last couple of years we have seen productivity at a healthy annual increase of around 2%, and as high as 2.9% in August, which has prevented a wage-price spiral from occurring. Despite this historical trend of productivity increases, some slowdown in productivity has recently begun which we believe may cause increased inflation in the future.

On a more positive note, the current slowdown in the housing market should control inflationary pressures because the decline in home equity values may cause consumers to reduce their spending, as demonstrated by a weakening of personal consumption expenditures in second quarter of 2007. This trend will ease the inflationary pressures caused by the strong employment and wage growth.

Therefore, we conclude that inflation from a demand point of view is kept in check by the current housing situation which offsets the effects of low unemployment. However, when the housing and credit situation straightens out, which we believe will be around the end of next year, we do not see inflation increasing coincident with a softening employment rate.

There does not seem to be significant pressure from the supply side – namely, production costs - that is affecting inflation. The only supply side inflationary pressure seems to be high energy prices, but this has been prevalent for the last three years without incurring any obvious core inflationary effects. Furthermore, the core producer price index (PPI), a leading indicator of inflation, has been tame remaining around 2.0%. Additionally, capacity utilization has remained between 81% and 82% which represents a normal non-inflationary level.



Given the recent developments, we expect inflation to be contained at around 2.5% through year end. We do expect growth to slow down from the 3.4% it posted last quarter to an annual rate of 2.5%. Given the Fed's predominant concern with keeping inflation in check, we think they will keep rates the same unless there is further evidence that the housing market continues to weaken and the credit situation deepens. We foresee the economy slowing further in late 2008, which will alleviate any pressure on the Fed to move rates higher prospectively.