

From J. Stephen Lee

## Is Inflation on the Horizon?

Crosscurrents in global economies, while abating in recent months, continue to be strong. Aggressive central bank action across the world appears to have



forestalled a systemic, global collapse, yet almost every new piece of economic data suggests only a slowing of the pace of declines, not sustained recovery. Stocks have rebounded off their March lows, having now — thankfully — moved beyond an “Armageddon” scenario, yet corporate profits remain weak and forecasts very cloudy.

**As we reset our sights from crisis management to considering sound future investments, one issue that comes to the forefront is inflation ... will it be an immediate or future worry?**

**Economics 101 tells us that many of the factors we see today** — massive government stimulus, record-low interest rates, rising oil prices, a shaky dollar — **are inflationary.** In Investing 101 terms, **this means that most bonds,** which currently offer attractive yields and have been sound performers, **are at risk from rising inflation.** Remember that bonds, with fixed coupons, typically react badly to rising inflation, which erodes the future worth of fixed payments. The opposite is also true — falling inflation makes those payments more valuable. So **paying attention to inflation is critical for bond investors.**

But hold on — **we believe it is time for an advanced course that suggests the worries about inflation are overblown** — at least for now. Here’s why.

**The global economy is experiencing a disruption akin to the turmoil in the 1920s and early**

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# Investment Commentary

From H.L. Zeve Associates Inc.

No. 65 August 2009

From Harvey L. Zeve

## Morningstar’s Stars: Use Only as Directed

Not many have missed the recent brouhaha over the safety of Tylenol and other members of the acetaminophen family.

**“The pain reliever that hospitals use most” has suddenly become super-high risk. Take too much and you could become gravely ill, or worse.**



**The same sort of cautionary advice can easily apply to investors’ behavior. If they overdose on Morningstar’s ratings, their portfolios can suffer serious harm.** At H.L. Zeve, we’ve been delivering that warning since Morningstar introduced its system 25 years ago. So has **Morningstar.** While the company is staunchly behind the system that continues to bring it fame and fortune — it steadily upgrades its research and analytical methods — it **has**

## Harvey Zeve, Steve Lee Named Top Managers

In a survey of 41,000 high-net-worth individuals and 6,100 financial services professionals, Harvey L. Zeve and J. Stephen Lee were each named one of Pittsburgh’s 2009 Five Star Wealth Managers. The announcement in the July issue of *Pittsburgh Magazine* noted that less than 7% of managers in the region received the honor.

**repeatedly urged investors to use the stars only as directed, not as a shortcut to riches.**

In a recent Morningstar newsletter, the writer, Katie Rushkewicz, makes this point in a number of ways. What she writes is similar to what we have said many times over. We think the information is worth repeating.

**Ratings are only part of the story. They might not include the entire performance history, or the management team might**

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“On the other hand, the price of a barrel of beer is holding steady.”

From Ronald W. Yost

## Oil Continues to Confound

You might think that by now we'd have done something more about oil.

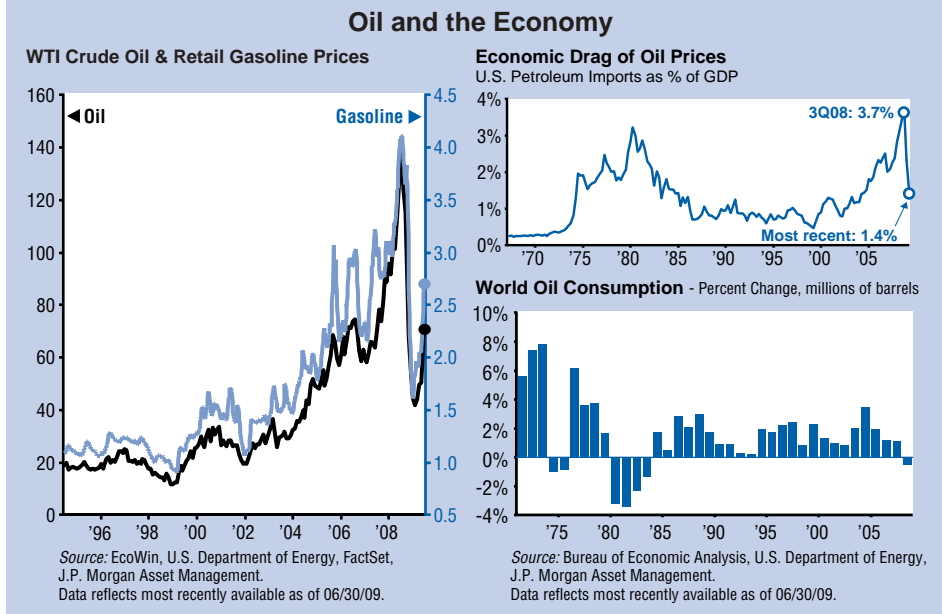
Unfortunately — perhaps predictably — we haven't made much progress, in spite of all the angst over oil prices and the worry about where we'll get supplies in the future — and how we'll pay for them. Yes, greater fuel efficiency, hybrid cars, alternative fuels and other "green" measures may be a start, but **nothing we've done so far will protect us if the price of oil goes through the roof and beyond.**



In 2008, the price of oil fell more than \$100 a barrel, going from \$146 to \$46. This year, it has moved up significantly. At this writing, the price of oil is \$67, and a gallon of gasoline is \$2.46. That's a worry. **Many trace the current recession largely to the spiraling of the price of oil from mid-2007 to mid-2008, when it reached almost \$150 a barrel.**

A study by James Hamilton, an economist at the University of California in San Diego, seems to confirm that opinion. Hamilton found that **exorbitant gas prices alone might have been enough to send our then-fragile economy into recession.** Sub-prime mortgages and the credit crunch could be considered icing on the cake.

**High gas prices have clearly had a far-flung effect.** Sales of SUVs and large autos — the backbone of the U.S. auto industry — declined dramatically, devastating manufacturers, dealers and workers. Between 2007 and 2008, 125,000 auto manufacturing employees lost their jobs. Even **the decline of home prices in distant suburbs is said to have**



**been exacerbated by the high cost of commuting.**

**So if oil prices continue upward, will our barely-recovering economy make a u-turn? Maybe not.** Between 2001 and 2006, the price of oil tripled without seriously damaging the economy. The likely reason is that those years saw stable inflation, low unemployment and relatively robust economic growth. In 2006, oil hovered between \$60 and \$70 a barrel, about the same as it is now. Thus, **although our economy still lacks vigor, the decline — especially in the auto industry — has already been so dramatic that another sharp nosedive seems unlikely. Unlikely, but not impossible.**

**Historically, major spikes in oil prices have sabotaged consumer confidence and led to hefty declines in consumer spending.** But there is always a psychological component to this scenario. **Economists can't predict when consumers will perceive a price rise as business as usual and when they will be spooked enough to turn off the spending faucets.**

Another issue has to do with **what's behind any spike in the price of oil.** The cause used to be a disruption in the supply chain. That's no longer the case. Now, **it's the**

**increasing demand from China, India and other growing countries.** And unless the worldwide economy goes into a tailspin, **that demand is unlikely to change.**

**Is there an answer? Tom Friedman, *The New York Times* columnist thinks so.** So does James Surowiecki, whose 6/22/2009 column in *The New Yorker* is the source for much of this article. **Friedman thinks the government should enact a tax that would stabilize the price of gasoline at \$4 a gallon.** Surowiecki doesn't mention a specific number. But **Friedman, Surowiecki — and other "experts" — see multiple long-term benefits** in such a move. For one thing, **there would be no surprises at the pump.** We would always know what to expect and could adapt our driving habits to fit our budgets. For another, **with no hope of cheaper gasoline, most of us would drive less and buy smaller cars** — conserving fuel and being kinder to our planet.

Can this possibly happen? Don't bet on it. **Most politicians see voting for a gasoline tax as a sure route to losing the next election.** And few voters are in favor of higher taxes of any variety. Still, **a couple of oil spikes that play havoc with the economy could change our way of thinking.** ■

*Zeve continued from page 1*

have changed. So investors whose sole focus is four- and five-star funds could easily miss lower-rated funds that have strong prospects. Or they could plunk money into what looks like a top performer without realizing its ratings are out of date.

Morningstar awards its stars based on a fund's risk-adjusted three-, five- and 10-year annualized returns. Funds are compared to their peer groups — large-cap to large-cap, for example. In each group, 10% get five stars; 22.5%, four; 35%, three; 22.5%, two; and 10%, one. **To be rated, funds need to be around for three years. Until they reach the full five-year milestone, the rating is based on the three-year performance.** The same holds true between five and 10 years. Thus, a nine-year-old fund could have five stars even though performance for its first four years was abysmal. Or it could have one or two stars although its first four years were stellar.

Rushkewicz cites a small-cap growth fund with a single star whose rating will undoubtedly improve when it reaches a 10-year anniversary in October 2009. She also mentions an international value-oriented fund that carried only two stars for several years, because it trailed its peers in

speculative markets — a common occurrence. On its 10th anniversary, the fund acquired two more stars by posting a 10-year record that beats 98% of its category peers.

**Management is another important issue. A low-rated 10-year-old fund with the same management surely deserves a pass.** On the other hand, **what the stars brand a loser could offer winning opportunities, if management has changed and performance has improved since the new team took over.**

Finally, funds too young to be rated are typically ignored but probably shouldn't be. True, **a new entity with untested management carries more risk than most should take on.** On the other hand, **when managers with a strong track record start a new venture that capitalizes on their experience, that fund deserves at least a second look.**

As we — and Morningstar — have said before, **star ratings are valuable tools — no more, no less.** They can be a good place to start or to confirm opinions formed from other sources. **Used in conjunction with research on fundamentals such as manager experience, strategy and expenses, they can lead to worthwhile investments. Used alone, they're a likely route to disappointing returns. ■**

*From J. Patricia Calhoun*

## Investors Raise Questions About Treasury Bonds

**Q. I've heard that Treasury bonds have been acting strangely and that their behavior has something to do with actions by the Federal Reserve. Can you explain what's happening?**



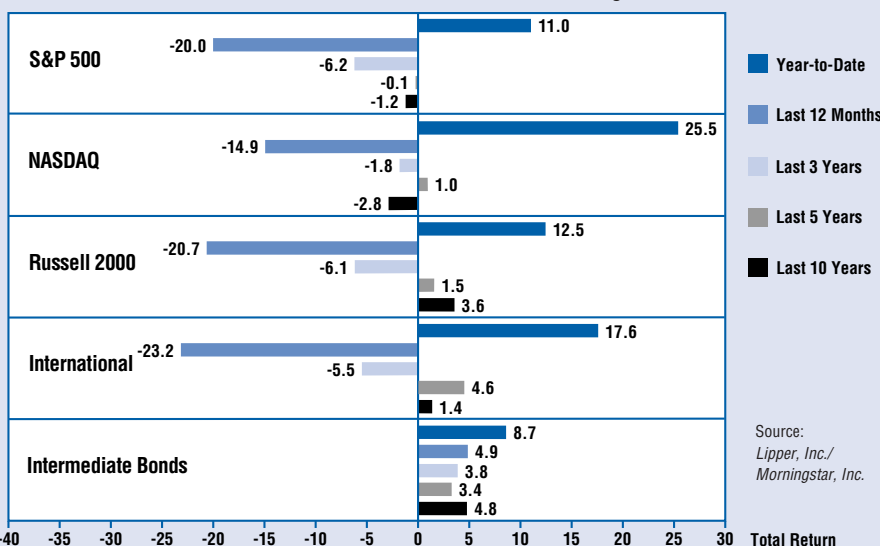
**A.** For many years, the Fed has controlled short-term interest rates by setting the rates at which banks lend to each other. Long-term rates, however, typically fluctuate based on how investors believe the economy will behave at given times in the future.

**But as part of its efforts to revive the economy, the Fed has been buying Treasuries and mortgage bonds as a way to keep long-term rates in check. These actions, according to some experts, are raising market volatility and keeping investors on edge.**

The Fed seemed to be buying bonds whenever rates approached 3%, and investors were following suit. But in April, the rate on 10-year bonds shot above 3%, largely because the U.S. flooded the market with new Treasuries, which depressed prices and raised rates. Traders quickly dumped their holdings, sending rates upward to nearly 4%.

Traders and managers are dealing with the current reality in a number of ways. **Some are skipping U.S. bonds in favor of the corporate variety** where prices basically reflect the underlying fundamentals. **Others are trying to capitalize on the Fed's actions with various buy-sell strategies that most investors would be wise to avoid. ■**

## Market Benchmarks Through 7/31/09



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## An Invitation

### The Zeve Essentials List Is Essential

The Zeve Essentials List, which we designed several years ago, helps you compile an inventory of your property and documents along with the names and phone numbers of people to contact for necessary information if something should happen to you. It instructs your heirs about your will, trust documents, bank and brokerage accounts, tax returns, deeds, real estate holdings, credit card accounts, insurance policies and other important data. If you've already completed a Zeve Essentials List and the information is more than three years old, it's time for a review. If you haven't filled one out, we urge you to do so now.

You can order your no-charge copy of the Zeve Essentials List by contacting Sandie Neff by phone (412-281-4567, 800-724-4765), fax (412-281-2725) or email (sneff@zeve.com). Or return the attached reply card.

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## Notices to Clients

A copy of H.L. Zeve Associates Inc.'s ADV Part II is available to all clients without charge. If you would like a copy of this document, please send a written request to our office.

A copy of H.L. Zeve Associates Inc.'s Proxy Voting Policies and Procedures is available to all clients without charge, as are voting records for your holdings, if applicable. These Policies are designed to ensure timely, careful proxy voting, with the best economic interest of clients in mind. If you would like a copy of this information, please send a written request to our office.

H.L. Zeve Associates Inc. has adopted a Code of Ethics as required by the Securities and Exchange Commission. Maintaining the highest standards of ethical business practices has always been a priority for H.L. Zeve Associates. It is the belief of the Firm that this is a critical component of continuing long-term success. The Code outlines the policies and practices in place to ensure the continuation of these practices, and is available without charge by providing a written request to our office. ■

## Credits

Parts of some articles were based on the following sources:

*Morningstar Mutual Funds, Katie Rushkewicz, April 21, 2009, "Morningstar's Stars: Use Only as Directed."*

*The New Yorker, James Surowiecki, June 30, 2009, "Oil Continues to Confound."*

*Business Week, Ben Levisohn, July 6, 2009, "Investors Raise Questions About Treasury Bonds."*

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## Mail or Fax

- Send me the Zeve Essentials List.
- Call me to schedule a portfolio review.
- I am not interested in receiving *Investment Commentary*. Please delete my name from your mailing list.

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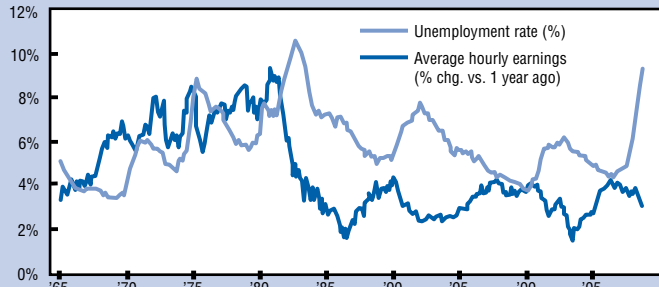
**1930s**, when the Great Depression ravaged the United States. Although it appears that catastrophic risk is now lessened, **an economic recovery from such events will be much different than what we have experienced over the past 60 years.** This has been far from a “normal” economic

likely stay high for an extended period of time, because **businesses will grow more slowly and with less leverage (debt). Foreclosures and bankruptcies are rising. Industrial production and capacity utilization have plunged,** (Chart 2) resulting in major economic slowdowns in countries worldwide. Put all this

**for a slower-growth, higher-inflation environment several years down the road.**

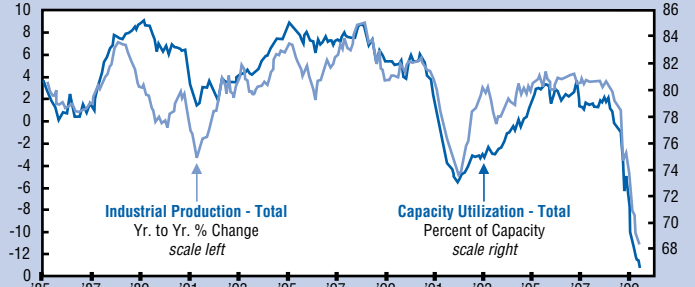
**The H.L. Zeve response over the past 18 months has been to decrease risk in clients’ portfolios, and we do not see that mindset changing. Our clients’ accounts today are overweight**

**Chart 1: Unemployment and Wage Growth**



Source: BLS, U.S. DOL, J.P. Morgan Asset management. Data as of 6/19/09.

**Chart 2: Industrial Production and Capacity Utilization**



Source: Federal Reserve Board

cycle. **The world is undergoing a massive “deleveraging”; i.e., a rebalancing of debt and savings, as the excessive spending of consumers and businesses over the past 20 years changes to a greater emphasis on saving.** The personal savings rate in the U.S. has climbed to 7% after being near zero for many years, and corporations are struggling mightily to reduce debt.

**The ramifications of these changes are wide and deep. Unemployment in the U.S. is nearing 10%** (Chart 1), and will

together, and **employee compensation costs**, which JP Morgan calls “the single most important factor determining U.S. inflation,” **are likely to remain muted for some time as we experience a period of slow and bumpy growth worldwide. Hardly a recipe for runaway inflation.**

Yet — as several top managers have noted — **it would be a mistake to conclude inflation worries are gone.** In other words, **many of today’s actions, while heading off economic disaster, appear to be setting the stage**

**bonds and have benefited from that step.** Highest quality municipal, corporate and agency bonds continue to offer attractive risk/reward characteristics, and we believe this will continue for the immediate future. Yet **over the long run, we firmly believe in the merits of balanced investing with an emphasis on high quality stocks for growth.** We will continue to monitor this evolving dynamic closely, and expect to continue to make changes as events unfold. **But for now, our answer to the inflation question is ... not yet. ■**

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