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EXPERIENCE TRUST COMMITMENT

You Can't Eat an iPad.

Bill Dudley, Federal Reserve Bank of New York President, told a Queens, NY Chamber of Commerce meeting in March that there was no inflation threat. As an example, he pointed to the fact that the new iPad2 has twice the computing power of the iPad1 but still costs the same to buy. It was at this point an audience member shouted to Dudley that "I can't eat an iPad!"

As we've discussed in earlier letters, the Federal Reserve focuses on "core" measures of inflation stripping out Food and Energy costs due to their view that these components contain too much volatility and add too much statistical noise to the true measure of inflation in the economy. As we've also noted, the rest of the world's central banks view food and fuel costs – things everyone needs to survive on a daily basis - as an integral part of the inflation calculation and use "headline" inflation (as opposed to core) as the true measure of price pressure in their economy. This is also how they measure inflation in Queens by the way...

Inflation: threat and response

Prices are rising – this is a fact. Whether it's a gallon of gas or a loaf of bread or college tuition prices are rising. Wal-Mart CEO Bill Simon gave an interview in the March 31st edition of the USA Today and stated inflation is "going to be serious" and that "every single retailer has and is paying more for the items they sell, and retailers will be passing some of these costs along (to consumers)". Some of the price rises have already occurred but have gone unnoticed because companies hide inflation from consumers. The March 28, 2011 edition of New York Times ran a story entitled "Food Inflation Kept Hidden in Tinier Bags" and talked about how companies are shrinking content weight and changing packaging while maintaining the price as if the original amount of product remained. Canned vegetable portions are now 13 or 14 ounces vs. the original 16 ounces but are still at the original 16 ounce price – a de facto 12-18% price hike! This is but one example of thousands of stealth price increases and it's not just restricted to food prices. Wonder why "slim fit" dress shirts are in fashion these days for men? Hint: It's not because American men have suddenly gone on diets. It's because the price of cotton has jumped by over 250% since January of 2010 and retailers need to cut cotton usage in products to preserve profit margins.

So prices are rising for necessities and the Fed is focused on nonsensical core prices – which are also rising, but by a much smaller magnitude. Why does this concern us and why should you be concerned? What worries us is that the smaller increases in core inflation is giving the Fed confidence that they can keep their policy of Quantitative Easing (QE or printing money- whichever you prefer) in place without causing a spike in inflation (as judged by their inflation metrics). The reality is the Fed is playing a dangerous game of Inflation Chicken and if they are wrong and inflation accelerates we could be facing persistently high inflation for goods and services and an increased loss of purchasing power of our hard-earned dollars for a long time to come. While the Fed continues along the money-printing path, Chairman Bernanke says that even if their numbers are wrong and the inflation genie is let out of the bottle, the Fed will be able to act quickly and decisively to put it back in. Their track record on recognizing and decisively acting on imbalances is not good. Here are some oldies but goodies from Chairman Bernanke:

*"Housing markets are cooling a bit. Our expectation is that the decline in activity or the slowing in activity will be moderate, that house prices will probably continue to rise."
February 2006*

*"The Federal Reserve is not currently forecasting a recession."
January 2008*

*"The risk that the economy has entered a substantial downturn appears to have diminished over the past month or so."
June 2008*

QE2 ends: What comes next?

Remember that Chairman Bernanke's goal of QE2 was to inflate stock market prices – based on this criterion he has been successful:



As you can see from the above chart of the S&P 500, the Market responded favorably to the massive money printing efforts. The big concern facing the Market going forward is what happens when the printing presses stop? The Market retreated after the end of QE1 and only resumed its upward climb when Chairman Bernanke hinted at the coming of QE2 and then followed through with an additional \$600 billion in stimulus. The Fed has announced that this most recent round of stimulus will end in June.

What this end of massive liquidity will do to the Markets is anyone's guess, however looking back at the past instance where QE efforts end has generally resulted in increased volatility and sideways to down Markets. While we believe that higher inflation is inevitable, it will not be a linear function because of the Fed's start-stop practice of QE.

Our playbook for the end of QE2:

Until the Fed's intended path (to QE or not to QE) becomes clearer we will be increasing the level of cash in our portfolios in the coming weeks. While we are cautious about the Market overall, we are constructive in certain sectors and asset classes. We would like to discuss two areas where we hope to find opportunities; Biotechnology and Bank Loans.

Biotechnology: a 20+ year opportunity

We believe the biotechnology sector is in the early stages of a multi-decade Bull Market. Several factors lead us to this conclusion. The pace of drug discovery should increase dramatically going forward due to cheap and plentiful computing power. No longer do biotech companies need to build costly proprietary supercomputers to process complex molecule interactions necessary for drug discovery. Distributed computing (or "Cloud" computing) can now leverage massive server farms run by companies such as Amazon and Google for a fraction of the cost and will yield

results quicker than an in-house solution. Quicker results shorten the drug discovery timeline and allow companies to process data in weeks and months instead of years.

2011 marks the first year of the Baby Boom generation entering retirement. An average of 10,000 Americans will file for Social Security every single day for the next 20 years! America is aging and with age comes age-related diseases: Alzheimer's disease, cancer, arthritis, type-2 diabetes and cardiovascular disease, among others. The quality of life for the Boomers will be critical for the welfare of the American economy – keeping people healthy longer will help to ease the costs of healthcare for Medicare and Medicaid, as well as for families and individuals. It is imperative that we solve as many age-related diseases as quickly as possible and the biotechnology industry is at the center of this.

Finally, big pharmaceutical companies such as Merck, Eli Lilly and Johnson & Johnson see increased generic competition on blockbuster drugs, massive pricing pressure and a dwindling new product pipeline. At the same time they are sitting on record levels of corporate cash and need to increase shareholder value. Instead of plowing more money into additional and questionable R&D, they are looking for biotechnology companies in mid-to-late stage drug development that they can partner with or acquire outright. Merger and acquisition activity was robust in 2010 but looks to gain even more momentum going forward as price and pipeline pressures increase.

Bank Loans: implicit interest rate hedge

With the Fed ending Quantitative Easing in June, current interest rates near historic lows and the U.S. Treasury needing to borrow huge amounts of money to keep the government solvent, we believe that Bank Loans offer a measure of protection from rising interest rates while providing a healthy level of income. Bank Loan funds (also known as floating-rate funds) are mutual funds which invest their portfolio in loans made to corporate borrowers. The rates on these loans fluctuate along with market rates. The rates are typically based on the London Interbank Offered Rate (LIBOR) which is the reference interest rate upon which most banks make short term loans to each other. Most loans have short maturities of less than three years and coupled with the floating rate component, can help to insulate investors from a rising interest rate environment. In our current ultra-low interest rate environment, we believe the path of interest rates will be higher and bank loan funds will play an important role in hedging this threat.

There are risks associated with bank loans and we are mindful of them. Typically bank loans are made to companies that are less than investment grade and it is important to monitor the average credit quality of the loan portfolio. Many of these loans are "secured", by which the company receiving the loan pledges assets in exchange for the credit and the lender has specific recourse if the borrower defaults. Because of this, loan investors typically have a greater chance of getting their money back in a default situation than bondholders. We prefer our bank loan managers to invest in the higher credit quality and secured loan spectrum. Bank loans are highly correlated with default assumptions and as an extension with the business cycle in general. We believe the economy is in a fragile but real recovery and current default assumptions are low. If circumstances were to change and default assumptions were to increase we would immediately move to exit the position.

Our goal is to position the portfolio for the best outcome but we are always mindful on what the worst scenarios could bring. Preemptively raising cash will place us in the best possible position of flexibility to respond to events as they unfold leading up to and immediately after the end of QE2. Adding bank loan funds to the portfolio will also help with interest rate volatility – especially if rates rise. In any case, it is our belief that an established investment discipline is critical during periods of potential market volatility. We value the trust you have placed in us as we remain stewards of your wealth.

Investing in mutual funds involves risk, including possible loss of principal. The market value of floating rate funds will fluctuate with changes in interest rates.