

Market Commentary

Invented Fears

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In addition to ongoing worries about domestic terrorism and international unrest, over the last quarter the stock market has been fixated on two major fears: inflation and what the Fed's reaction will be in setting interest rates. While rising inflation and interest rates have historically bedeviled the stock market; there are substantial differences between the economic situation today and in the past. We'd like to address what we think are the facts and fiction of the current situation on these two fears.

One of the reasons the Federal Reserve was able to cut interest rates substantially over the past ten years and recently to maintain rates at or near 40 year lows has been extraordinarily low levels of inflation. In the 1970's and early 1980's the Fed aggressively raised interest rates because of unrelenting inflationary pressures, which reached as high as a 13% per year increase in the Consumer Price Index.

In contrast inflation has averaged less than 3% annually over at least the last decade. Thus the Fed could meet its mandate to combat inflation without increasing interest rates. Low inflation in the last decade has been attributed to increases in productivity (more output for less cost), increased foreign competition which gave American companies less flexibility to raise prices and labor less opportunity to increase wages beyond that justified by productivity, and persistently low commodity prices (particularly oil). In fact until recently many economists and the Fed have been more concerned about deflation than inflation.

Today there is a worry that inflation will increase substantially because of rising commodity prices caused by increased demand from China's rapidly growing economy, and unrest in the Middle East which has caused oil prices to exceed \$40 per barrel. While these are valid concerns, they don't tell the whole story. China has already taken steps to rein in their economy and thus reduce their demand for commodities. While oil at \$40 per barrel is of concern, it is important to separate the portion of that \$40 price which is the result of underlying supply and demand from that which is caused by fear. It is impossible to make this allocation exactly, but it is generally agreed that \$5 to \$10 per barrel of the price is due to geopolitical worries.

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We are also less concerned about these supposed current inflationary pressures because the importance of oil to U.S. economic growth has decreased. Some estimates are that it takes about half as much oil to produce a dollar of domestic economic growth today than it did in the 1970's. Additionally we are less concerned because unemployment is still at very high levels and foreign competition continues to be a constraint on price increases thus the likelihood of wage—price inflation (the most worrisome type) is reduced.

Related to the worries about inflation are those about interest rates. While there is no clearly defined neutral or normal level of interest rates, it is generally agreed that short-term rates are currently about 2% below what would be viewed as neutral or normal. The Fed has maintained rates at this level in order to stimulate the economy and create job growth. Today the Fed is contemplating raising rates not because of inflation but rather because the economy is starting to rebound and the economic stimulus of low rates is no longer as important. The Fed could raise rates 2% from the current level and still only be back to a normal level by historical standards. While this might somewhat restrict economic growth, the amount of such restriction would not likely be excessive. Instead of worrying about rates going back to normal levels, investors should be focused on the economic rebound which has made this possible.

It has been said that if there isn't something to worry about, investors will invent something. We think the current fears about rising inflation and interest rates fall into that category.

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