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Deflation Avoided ... Inflation, Not So Much

The good news is that The Federal Reserve Board has achieved its goal of avoiding deflation.

Of course with the price of gas approaching $4 a gallon and unemployment levels still close to 10 percent, few Americans are rejoicing about prices not going down.

The Fed could not have predicted the Japanese earthquake-tsunami-meltdown or revolution throughout The Middle East when it decided to boost inflation with quantitative easing (QE2), but these events have not changed The Fed's approach of weakening the dollar and boosting inflation by printing more money and buying Treasury bonds.

Even before the crisis in Japan, inflation was showing signs of accelerating. In February, wholesale food prices posted their sharpest increase since 1974, and prices of gold and various other commodities have been at or near their all-time highs.

The Fed believed that the still-lackluster economy would keep inflation from accelerating too rapidly. But now?

Japan accounts for about 9% of the world's economy. This unfortunate country will need to import supplies and will be unable to export much for the foreseeable future, as there is not much demand for radioactive cars. As one example, Japan accounts for 25% of the world's production of semiconductors, so prices are likely to soar.

The Middle East is, of course, the world's largest source of oil. Revolution there has boosted oil prices here, but so has the weak dollar

and the U.S. hold on drilling new wells. An increase in oil prices ripples throughout the economy, affecting prices for food and many other products.

Given all of these factors, an increase in inflation is a given. The question now becomes how much of an increase in inflation can we expect?

Annual Inflation Rate

Current		1976 - 1987	
Year	Ave	Year	Ave
2010	1.64%	1987	3.66%
2009	-0.34%	1986	1.91%
2008	3.85%	1985	3.55%
2007	2.85%	1984	4.30%
2006	3.24%	1983	3.22%
2005	3.39%	1982	6.16%
2004	2.68%	1981	10.35%
2003	2.27%	1980	13.58%
2002	1.59%	1979	11.22%
2001	2.83%	1978	7.62%
2000	3.38%	1977	6.50%
		1976	5.75%

The Fed's Role Reversal

Since the nasty high-inflation days of the '70s, The Fed's main role has been to keep inflation in check. The Fed may be criticized about many other things, but it has performed that job quite well.

Over the first decade of the millennium, the highest inflation we had was 3.85% in 2008, but it was followed by a year in which prices dropped by 0.35%. During the '90s, annual inflation ranged from 1.55% to 5.39%. But in 1974, inflation hit 11.03%, and from the period 1979 through 1981, inflation hit 11.22%, 13.58% and 10.35%.

The Fed has reversed course because of concerns about deflation. Why worry about deflation? Prices drop when the economy is weak and consumer demand drops. When prices drop, profits decrease, stock

prices drop, and unemployment and bankruptcies increase. Consumers put off purchases and wait for prices to fall further, which contributes to even further deflation.

One area where deflation is a problem is the housing market, which continues to sink in spite of record-low interest rates. The U.S. Census Bureau reported that sales on new single-family houses were down 28% from a year ago - and last year's sales were abysmal.

Of course, in any given year, the average American is not buying a home and will not be affected by the drop in housing prices. Lower housing costs will not balance higher prices for oil, food and healthcare. And those who are selling their homes are doubly cursed by higher costs and a lower return on their home.

Technology prices have also continued to drop, but, as *The Wall Street Journal* recently put it, "You can't eat an iPod."

Back To the '70s

When prices increase, it means demand is outpacing supply. High consumer demand is a sign that the economy is improving. It means people are back to work and are spending money.

So an improving economy can result in inflation. But that doesn't mean inflation will result in an improving economy. Consider what Economics Editor David Wessel had to say in *The Wall Street Journal*:

" ... so far, the Fed hasn't had to choose between fighting inflation and fighting unemployment, its twin mandates, and it has kept the credit spigot open. It hopes growth will pick up and unemployment will come down before inflation gets going. But cross currents of the past few weeks could produce a less-pleasant scenario: Less growth and more inflation, accompanied by still very high unemployment."

Back in the '70s, we called that "stagflation." Get out your Whip Inflation Now! (WIN!) buttons. It looks like you'll be needing them.

Active Management Antidote for Volatility

In spite of recent strong performance, stocks could be in for a tough time ahead. Likewise, interest rates cannot remain at current levels forever and their rise could wreak havoc on the bond market.

Hedge fund manager Paul Singer recently warned against misinterpreting the rising stock market and said, "Of course printing money is going to support asset prices," but "it's very dangerous" and is

no substitute for trade, tax and regulatory reforms that make America an attractive place for job creation.

He also said that, should inflation accelerate, it will be difficult to tame. In the late 1970s, inflation was only in the high single digits, yet curing it required interest rates of 20% and a collapse of the bond market.

With stocks and bonds both in trouble, and increased volatility likely, a "buy and hold" investment strategy may be dangerous. Keep the 2008-2009 bear market in mind.

The most dangerous strategy in a volatile market is to do nothing, which is what "buy and holder" advisors recommend. Active management is designed to take advantage of volatility.

Wenning Investments has kept a larger-than-usual portion of client investments in cash to manage risk and be ready to take advantage of opportunities looking forward.

Q&A What Are TIPS?

TIPS, or Treasury Inflation Protected Securities, are an investment that can provide a hedge against inflation.

The principal for TIPS is adjusted for inflation monthly, rising or falling based on the Consumer Price Index (CPI). The CPI rose 0.5% in February - its largest increase since June 2009 - so $1,000 invested in TIPS at the beginning of February would be worth $1,005 a month later. As with other bonds, investors also receive income from yields.

Exchange-traded funds are one way to purchase TIPS and maintain liquidity, as you won't have to wait for your TIPS to mature to sell them.

TIPS may be worth considering if you think inflation will exceed expectations, but could be a poor investment if inflation is lower than expected. Also, if expectations for higher inflation cause an increase in demand for TIPS, prices will increase and yields will decrease.

Keep in Touch

Have an idea for a future issue of *Wenning Advice*? Are you interested in active investing or would you like to refer a friend who may be interested?

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