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COLUMNS

Keep an eye on the rising Misery Index

During the second quarter, inflation passed the 4 percent level, well above the Fed's stated range of 1 to 2 percent. Energy prices continued to rise. The economy stalled. Commentators fretted endlessly about "stagflation." Reacting to all this, the president took decisive action and imposed price controls!

The year was 1971, and those price controls turned a weak recession into a strong, prolonged recession.

Today's policy-makers face the same situation of finding the right solution to help the economy, but in a far more complicated, global economy. Factor in that it's an election year, and things can get very interesting for investors.

The president and Congress recently provided a rare demonstration of bipartisanship by speedily approving a "stimulus package," which started arriving in retailers during the second quarter. Beyond that, there is little policy help on the horizon.

Many look to the Fed to do the heavy lifting, but the Fed is simply less important in a securitized and globalized world, and cannot help as much as it used to. But, it tries.

After steadily lowering interest rates since last September, the Fed stood pat at its last meeting and strongly hinted the next action would be an increase. Actually, it didn't matter much because the market was already increasing interest rates, especially long-term rates, without waiting on the Fed.

Calculating misery

Popularized by President Carter in 1976, the Misery Index adds the inflation rate to the unemployment rate to estimate the degree of economic misery. A rising Misery Index is usually not helpful for incumbent political parties. During the first Bush administration it was 10.68 percent, and he was not re-elected. It averaged 7.8 percent during the Clinton administration. It is now at 9.68 percent and rising.

However, if you use May's Producer Price Index of 7.2 percent and the unemployment rate of 5.5 percent, the Misery Index is 12.7 percent... ouch!

And I'm not done dissecting that important number yet. Economists and investors have recently been debating the quality of the data we study. If the data appears to be either too optimistic or pessimistic, policy-makers will be misled.

Several controversial changes were made to the inflation rate computation during the first Bush administration that many believe caused a permanent understatement of rate, estimated at 3 percent. If that is the case, as I believe it is, the real Misery Index is closer to

15 percent, too high to prevent major political change. Is it surprising that consumer confidence is at a 28-year low?

Another change made to the Consumer Price Index calculation was separating headline inflation from core inflation. The idea was that headline inflation would vary above and below the core level, confusing policy-makers. However, the headline rate has consistently remained above the core rate for several years, while everybody has focused on the core rate, ignoring the real impact of the headline rate.

Bloomberg's John Wasik claims, "The U.S. consumer price index continues to be a testament to the art of economic spin."

Importing inflation

Looking at the first chart, we see the U.S. Headline CPI fluctuating widely around the 2.6 percent average (not core) over the last 10 years.

Looking at the second chart, we see the Foreign CPI Composite for 24 nations. That index is designed to estimate the world's inflation rate. It fluctuates less and averages 7 percent.

With the dollar so low, the risk of importing inflation is much greater. One analyst estimates the inflation rate of our imports is a staggering 17.8 percent. While this largely reflects rising oil costs, it also reflects the weakening dollar, which is good for our exporters, but it is now too weak. However, to raise the value of the dollar, the Fed must raise interest rates in this country, which will only slow the economy even more and increase unemployment.

The tricky dollar & the Fed

There are two types of inflation - cost-push and demand-pull. Recently, Dow Chemical announced two price

increases totaling almost 50 percent. This is cost-push inflation. The Fed can do little about that type of inflation.

When high overall demand creates an overheated economy, you get demand-pull inflation. The Fed can effectively decrease overall demand in the economy by increasing rates. But, that is not the problem in a stagflationary economy right now. Our economy needs stimulation now. In other words, don't expect the Fed to bail us out.

How we're managing it

The underlying economy remains surprisingly resilient, renewing my faith in capitalism. First quarter GDP growth was revised upward from 0.6 percent to 1.0 percent.

Technically, we are nowhere close to a recession, since there have not been two consecutive quarters of negative GDP growth. Frankly, that requires more faith in economic statistics than I can muster. I agree with Warren Buffett that we are in a recession, no matter what the technicians say. Just ask the 438,000 Americans who've lost their job this year.

I also agree with the latest forecast of Standard & Poor's that the bottom of this recession will not be before the first quarter of next year, and my investment firm has been selectively raising cash to take advantage of later "sales." The cash level varies from 10 percent to 40 percent, depending on the particular client's objective and risk tolerance.

The traditional investment axiom is that Wall Street anticipates and begins rising six months before the economy improves. The time to increase exposure to consumer discretionary stocks and financial stocks is approaching, but not quite yet.

With the Misery Index rising and a presidential election in November, the

incumbent party can expect strong headwinds. We are advising clients to take capital gains now and pay the low tax rate before it goes up.

Today's low asset values also minimize capital gains. It is a good time to rebalance portfolios, catch up on sector rotation, and increase exposure to special investment strategies such as infrastructure.

Now that large companies have returned to their traditional role of underperforming small and mid-size stocks, we are increasing exposure to mid-caps, especially those benefiting from globalization.

Convinced that the U.S. will remain hibernated, we continue to encourage clients to increase the exposure to faster growing parts of the world.

While I remain extremely bullish on commodities over the long run, I think there is a "bubble" in oil and I am paring back our positions or doing covered calls for the tax-sensitive. The grains, such as corn and soybeans, are also too high for holding any longer. When commodities come back to reasonable levels, we will re-invest then.

Most of all, I remind our clients to keep in mind capitalism's fundamental strengths, maintain a long-term focus, and look forward to all those good stocks going "on sale."

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