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Stagflation?

As the Fed battles inflation and a slowing economy, the threat of stagflation raises its head. Stagflation is not a word that has been in wide use lately, but it refers to that time in the 1970s when the economy suffered from inflation and a slowing economy at the same time. It was a very uncomfortable time as workers at every level saw their purchasing powers erode and lost their jobs because of a poor economy. Inflation ran at uncomfortably high levels. The cause at the time was primarily the high price of oil. In 1973 and 1974, we suffered from "oil shock": a shortage of oil, and high gasoline prices.

Currently the Federal Reserve is trying to slow inflation while the economy slows. The Fed feels obligated to keep interest rates at their current level to keep inflation in check while the economy slows markedly. The Fed has noted the slowing economy, particularly in the housing market, and has given itself some latitude to lower rates if needed but so far has not been inclined to do so. The markets are uncertain the Fed will ease, but seem to think that the Fed will be forced, by the slowing economy, to lower rates this year. However, recent strong jobs reports gave a jolt to the lower-interest-rate crowd.

We are just entering earnings season when companies announce their quarterly earnings, so we should learn much from those reports. Earnings forecasts have been declining. For several years we have had double digit earnings growth each quarter. Lately, however, analysts have seen earnings growth declining first to 6.7%, and more recently to 5.1% for the first quarter of this year. David Rosenberg, chief North America economist at Merrill Lynch, reduced his forecast for the growth of the U.S. economy to 1.8% in the first quarter from 2.2%. GDP growth in the 4th quarter of 2006 was 2.5%. As CEOs see declining earnings and economic growth, they are inclined to become more cautious in their spending.

Minutes of the March 20-21 Fed meeting released on April 11, 2007, show a Fed very concerned about inflation as they considered raising interest rates in a slowing economy. Yet, on April 10, Fed Governor Mishkin was quoted by Bloomberg as saying that inflation expectations were "well anchored", and that the Fed had been "quite successful" in bringing down inflation expectations. Confused yet?

In the meantime, oil prices remain stubbornly high, and with each international crisis (such as the British-Iran hostage crisis) spike higher. It should be noted that oil prices have doubled since the start of the Iraq war, and the dollar has fallen (making oil even more expensive, since the "Axis of Evil" speech). The Bush administration's solution to high oil prices is Ethanol. This is a very good political move as it shores up support in farm states, as the price of corn has jumped. (The

government also subsidizes ethanol at over 50 cents per barrel to make the price more competitive with fossil fuels.)

Since the higher price for corn and other feed stocks have risen, the prices of animals for slaughter, and therefore food has been pushed up too. So the effort to push down oil prices and make us less dependent on foreign oil is inflationary in and of itself. The plan seems doomed anyway since the production of ethanol actually uses more fuel than it produces, it is difficult to transport (it cannot go through pipelines and can only be transported in special trucks), only 1,100 out of 170,000 filling stations in the nation sell ethanol, only one in California, and foreign car makers are shunning ethanol. This is a good example of how geo-political events can affect domestic policies and economics.

Which leads to my next point, while the U.S. economy is slowing, parts of the global economy are still strong. If the U.S. slips into recession as Sir Dr. Alan Greenspan predicts (but is "uncertain") then the world will suffer. But if we merely slow down, other parts of the world should continue to grow. It is noteworthy that for the first time since before the first World War, European markets (24 including Russia and emerging Europe) exceed the capitalization of the U.S. markets. This is certainly a notable event for many reasons, but it does demonstrate that one needs to have exposure to foreign markets, not only for growth but also for diversification.

This past quarter the markets acted in line with a slowing economy. With the Dow down .19% and the S&P barely positive at plus .64%. With the economy slowing and inflation a persistent problem, we cannot expect much from the markets this year. This will be another year that tries investors' patience. We need to remember that we are long-term investors. Despite all the trying times and crises we have had since 1987, the S&P including dividends has returned 10.6% per year.

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