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Building Better Futures

A View from the Top:

Inflation, Interest Rates and the Markets

Summer 2006

The May and June financial markets reminded us in a pretty convincing fashion that they remain unpredictable and that volatility is alive and well. The benchmark S&P 500 returned – 1.54% YTD through 6/26/06. With higher inflation and slower economic growth, the expectation was that 2006 would provide a lower investment return……….. and it looks like that expectation will be met.

Here's where some of the other indexes are YTD through 6/26/06:

Russell 2000 Index for Small*	- 3.10%
MSCI EAFE (US$) Intl Index*	- 4.54%
MSCI US REIT Index*	9.34%

*Indexes don't take into consideration expenses associated with investment.

It is pretty obvious that there haven't been many real gains so far this year. We had a solid first quarter and then May and June have been very negative markets. Some of the volatility is being driven by profit-taking by large institutional investors who can move money very quickly with computerized trading. The rest is being driven by uncertainty due to questions about where inflation is really going to settle and what the Fed's (Federal Reserve's) next move will be.

Inflation and Interest Rates

Concerns over inflation, interest rates and economic growth continue to cause worries on Wall Street. For our well-diversified portfolios, we experienced a short-term worse-case scenario. Many asset classes that do not typically work together actually ended up going in the same direction which during this period was down.

There is a lot of discussion about whether the economy is slowing down or if it will continue to grow at a slower rate. Key economic indicators are sending mixed signals to folks that are watching them. Consumer spending overall has remained healthy, but we are starting to see some slowdown in some retail markets such as at Wal-Mart. The slowdown at Wal-Mart may be an indicator that higher gas prices and rising borrowing costs may be impacting the pace of consumer spending.

This slowdown in spending could be an argument for the Fed calling off its two-year-old rate-increase campaign. There is much speculation about whether the Federal Reserve will continue to raise rates or if it will put a hold on the increases. Inflationary factors will certainly continue to be a cause for concern with the rising prices of commodities, including oil and gasoline. The most recent downturn in gold and some other commodity prices could actually be telling us that prices have gone up much too quickly and have gotten ahead of inflation.

Gloomy reports on employment provided some additional indicators that the

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economy may have reached a critical point. The important variable at this stage is what policymakers do in response to these latest indicators. Their actions could drive what happens in the economy in the months ahead.

Some believe the weak employment number indicates the economy is slowing down from its strong rate of growth in the first quarter. This would mean that this slowdown could be enough to keep the Fed from tightening any further when policymakers meet at the end of this month. But others aren't quite ready to say that the Fed should take a break.

But let's back up for a moment and talk about why the Federal Reserve raises interest rates and how that relates to the financial markets.

The Federal Reserve Bank was created to oversee the economy. Controlling the discount rate is one method that it uses to manage the economy. The discount rate is the interest rate that financial institutions pay to borrow money from the Federal Reserve. When the discount rate is high, banks make fewer loans because it costs more to borrow money to use for these loans. This means that individuals and businesses have less money to spend which may lead to slower growth in the economy. When the discount rate is lower, banks make more loans because they don't have to pay as much to borrow the money from the Federal Reserve. The Fed reduces the discount rate to increase the dollars available to businesses and individuals for spending which then helps to fuel the economy.

Now that we have a better understanding of why the Fed has been raising interest rates, the real question is will it continue to increase the discount rate or does it believe it has done enough. Looking at some of the recent reports, I expect at least one more increase before Bernanke is comfortable that inflation is under control. My primary concern is that Chairman Bernanke will be overzealous in fighting inflation and make one move too many in terms of raising rates. This could slow down the economy to the point that we could edge into recession. I don't believe that this will occur, but we always have to be prepared for the worse-case scenario.

The financial markets are concerned first with inflation, second with profits and third with our new Fed Chairman and the uncertainty of what he will do in the future. Uncertainty always creates volatility in the financial markets because we are all making decisions about the future and hate uncertainty at any level.

Those of us who believe in diversification and a little longer-term view have to go along for the ride until the dust settles. In the meantime……. where we have cash to invest we will begin moving into the market more aggressively over the next month or so to take advantage of the volatility and the lower current prices. As you know, we don't have a crystal ball. Having said that……………. I do believe that the markets will settle over the next few months and move higher toward the end of the year.

Here's our mantra to repeat as we watch these markets go up and down: we are not market timers; we are long-term investors. The financial markets go up and down in a **never-ending cycle**. Even though we really want them to go up forever – *we know they never do.* **Each phase will pass, and we will continue to see up and down stock and bond markets.**

Have a great summer and let us know how you are doing.

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