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Fear and Inflation

By Lawrence E. Howes, MBA, CFP®

This recovery, as it continues to take shape, is showing some similarities to many other market recoveries that we have seen. Granted, market recoveries are unique to be sure, nevertheless all recoveries tend to wander down some of the same roads. We have been buying in this curious market since December 2008, and it is clear to us that prices have been really cheap for companies worldwide and there are still bargains out there if you are willing to look. However today, the markets seem to be focused more on investor fear than what opportunities are most prevalent going forward. Opportunities are where new wealth is created and where we will recoup our portfolio loses, but basic investor fear is still a commanding force.

Now, we are at the stage in this recovery where interest rates need to rise a bit, and if you have been watching, rates have indeed gone up. Mortgages are no longer 4.75%, but 5.90% and as of this writing, still rising. Money is getting tighter to a large degree because there is \$1.2 Trillion in new US Government debt out there and the bond market needs to provide buyers for this colossal heap of red ink.

This surge of government debt is funding the various bailout and stimulus packages, and interestingly enough, many of the recipients of this government money are issuing their own debt to get out of the grip of the Government's bailout. Needless to say, sometimes following the pea, as it is transferred between the shuffling cups, can be a challenge.

The stock market has been acting pretty confident that the worst is over and many positives are coming our way. The bond market however has been brooding over the piles of new debt to be sure; but it is also showing concern over how inflation is going to impact this recuperating economy. Clearly inflation is coming, but the media hype about hyper-inflation (greater than 12%) or even high inflation (greater than 6%) is likely just that, hype.

Inflation, if it is causing high interest rates, is bad. If you want to encourage economic growth and spending, low interest rates would be much better. Unfortunately, when anything is for sale, in this case Government debt, it tends to get cheaper when supplies are plentiful, and the supply of debt is very plentiful indeed. Debt gets cheap because its price goes down, and when the price goes down, the rate (or yield) goes up. Rising interest rates usually equate to rising prices, and rising prices are the root of inflation. The possibility of such an inflation spiral will be paraded to all investors via the media pundits for many months to come so be prepared to be bombarded with this type of scenario.



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All this debt by itself is not really enough to drive inflation past 3-4% in a \$13 Trillion dollar US economy. Other factors are needed like wage pressure, limited production capacity, excessive consumer and corporate debt, and excessive consumer and corporate spending - all acting in concert to push prices up. We have none of these pressures with little likelihood of seeing any in the foreseeable future.

The US consumer is shaken and still retrenching. Most consumer spending is focused on either paying bills, if possible, or simply saving. Homes are no longer easy ATM machines. US corporate debt outside of banks and financial service companies is at historic lows. US manufacturing capacity is significantly underutilized and there is gigantic global capacity available. These factors all limit the impact of inflation.

The driving force behind any future inflation is most likely going to be the amount of Government debt and the capricious and volatile price of oil. Both of these can be controlled somewhat, by the Government spending less on stimulus and the consumer using less oil. Both of these factors are complex and will take some hard choices and positive action by both parties to resolve. We know this is not a new debate, so we shall see. The likelihood of uncontrollable or unforeseen inflation sneaking up on this economy, like it has in the past is remote. Even the policymakers in Washington are aware of these trends and understand what must be done. Don't worry about inflation taking over, worry about the fear of it bringing more carnage into these fragile markets.

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