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Inflation fears overdone

VIEWPOINT

By **ERIC B. PARNELL**

Investment markets have recently been paralyzed over inflation fears. Since the market bottomed out several years ago, investors had been enjoying a market where the threat of major price increases was largely nonexistent. But this relaxed view began to change dramatically several months ago, as spiking oil and raw materials prices coupled with an extended period of record low interest rates created the ideal breeding ground for an inflation spiral. And it has been these inflation fears that have helped keep a lid on the market since its last peak in early May. Despite these justified worries, the good news is that many structural forces are in place that should keep inflation largely in check going forward. This is good news for investment markets.

So with gas prices soaring to over \$3 a gallon, what are the factors that are keeping inflation under control? The first important influence is continually strong productivity growth among U.S. companies. What is productivity? It is the amount of goods and services that a company is able to produce with its available labor and capital resources. When companies are experiencing strong productivity growth, it means that they are able to make products and provide services more efficiently and at a lower cost. This allows companies to still make money selling their products even though the cost of inputs needed to make these products such as energy and raw materials are rising.

A second factor helping to keep inflation in check is strong competition from overseas, particularly Asia. Given that we live in a global economy, if the seeds of inflation were going to start anywhere it would likely be China, which has been experiencing rapid growth over the last several years behind its standing as a leading global producer of manufactured goods. But instead of inflation coming out of China and Asian neighbors, we are instead seeing more signs of deflation than anything else. This is due to the fact that, much like the U.S., productivity growth is strong in China and

across Asia. In addition, the cost to manufacture products is being held in check by the ample supply of low cost labor in China and across the region. As a result, the U.S. is continuing to receive a flood of inexpensive goods from Asia. And if American companies want to remain competitive against these low cost imports, they can't afford to raise prices on their own products.

Putting this all together: companies would rather not raise prices on the goods they sell because they need to compete with low cost imports. Because of high productivity growth, companies are still making money on the products they sell and don't necessarily need to raise prices anyway. And because of higher interest rates and energy costs, consumers aren't showing the ability to pay higher prices for goods. Instead, consumers are having an increasingly difficult time buying goods even at current prices. These are all powerful forces that are coming together to limit inflation pressures in the days and months ahead.

What does all of this mean for investment markets? An easing of inflation fears would be positive for the bond market. Once bond investors can conclude that the economy is slowing and the U.S. Federal Reserve is finished raising interest rates, Treasury yields should start to head steadily lower, which means that bond prices would be heading higher. The outlook for stocks is also positive. Although the economy appears to be slowing, companies are financially healthy and are expected to maintain positive profit growth. And given that stocks are trading at the most attractive valuations in nearly two decades, the potential upside for stocks from a price perspective is also positive. One more added boost: investment markets have historically done well once the U.S. Federal Reserve has finished raising rates, which we are now seeing take hold with the Fed's first pause in hiking rates in over two years on August 8.

So while nobody can be sure what the future holds for investment markets, there are good reasons to be optimistic for the future despite the inflation worries holding the market in flux today.

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