Navigating Interest Rates, Inflation and the Economy

These are tricky times for American investors and consumers in general. The economy seems to be cooling down! The second quarter GDP rose just 2.5 percent, down from 5.6 percent in the first quarter of 2006 and below its average of 3 percent during the recent expansion. And the housing market, perhaps in reaction to 30-year fixed rate mortgages above 6 percent in late July, also seems to be slowing down: Sales of new homes fell 3 percent to 1.13 million homes in June and revisions to data released by the Commerce Department also showed the U.S. housing market was weaker in the first quarter than previously reported.

Meanwhile, recent inflation and spending data show inflation to be at an 11-year high. For instance, The Federal Reserve's favored inflation gauge -- the core personal consumption expenditure price index -- increased 0.2 percent for the third straight month in June. Core inflation, excluding food and energy, has risen 2.4 percent in the past 12 months, matching the largest year-over-year gain since the spring of 1995. Consumer prices including food and energy also rose 0.2 percent in June, and were up 3.5 percent in the past year. As a reference, the 20-year average annual rate of inflation was 3 percent.

The cross currents of a cooling economy and housing market with rising prices and the threat of wage pressures has left the Federal Reserve in a bit of bind. For the past two years, the Federal Reserve has been increasing short-term interest rates as part of an effort to slow down the economy and inflation. But while the Federal Reserve has indeed slowed the economy, it has yet to bring inflation under control. The main culprits are surging raw material and energy prices – the average gallon of unleaded gasoline hovering around $3 – over which the Fed has little control.

This coincidence of an inflationary threat with a slowing economy has led some to raise the prospect of the return of something not experienced in decades – stagflation.

Stagflation occurs when economic growth stalls and inflation continues to rise. According to Wikipedia, the online encyclopedia, stagflation is considered to be a problem because most tools for influencing the economy using fiscal and monetary policy are thought by some analysts to be based upon the trade off between growth and inflation. "Either they slow growth to reduce inflationary pressures, or they allow general increases in price to occur in order to generate more economic growth." Stagflation creates a policy bind wherein attempting to correct one problem exacerbates another. However, although some similarities exist in the form of rising oil prices and inflationary risks, there is little in the current situation to indicate the return of the stagflation of the '70s. Economic growth, while showing some signs of slowing, remains generally strong. And the forces of globalization and the global competition that results, in the context of world wide central bank restraint, make serious inflation less of a threat than in the earlier period. The more serious threat today is that the Federal Reserve will go too far, resulting in a recession.

For investors, the upshot of the unholy combination of rising inflation in a cooling economy might be devastating. What can an investor do? Investors might consider repositioning your investment portfolio by shifting a portion from stocks to bonds. Putting a larger portion of funds into high-quality, long-term bonds, such as the 10-year Treasury bond, is one strategy since these had a yield of 4.98 percent at the end of July.

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According to financial planners, if the Fed keeps pushing the button marked “increase short-term interest rates” too long, a mild recession could result. Should this happen, market interest rates would come down in response and a bull market for long-term bonds would result, with the price of bonds increasing. Likewise, experts also recommend using five-year certificates of deposit to produce income. High quality CDs that mature in five years had a recent yield of 5.04 percent.

On the equity side of a portfolio allocation, investors might also want to consider investing more in high-quality, dividend-paying stocks. Stocks of companies that pay out a good percentage of their earnings as dividends generally have less price fluctuation than stocks of non-dividend payers. The dividend represents a big part of the return, which often smooths out price volatility of those stocks. More often than not, large companies, such as those that are part of the Standard & Poor’s 500 stock index, pay high dividends. The current yield of the S&P 500 is, for instance, 1.86 percent.

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