

## October turnaround in the cards

by Stephen J. Butler



heer up. The depth of our despair, from an economic standpoint, is scheduled to take place on or about October of this year.

The balance of the summer will be rough with lots of bad news on the economic front, but behind the obfuscating veil created by the news media, things are already looking better. How do I know this? Because I spend most of what I earn from writing this column to access monthly information from the Institute for Trend Research, the latter being a think tank of economists located in a backwater of New Hampshire. Headed by twin brothers, Alan and Brian Beaulieu, the institute publishes charts and graphs and distills them into a computerized brew that has been remarkably accurate at predicting future economic events over many years.

In a recent speech in San Francisco, Alan Beaulieu pointed out that we were approaching the economy's nadir, as the financial services sector, the first of several leading indicators, was starting to show signs of a turnaround. It doesn't take a genius to recognize that the stock market is making a comeback, and the bond markets are firming up as well. Traditionally, financial markets lead the economy by about six months, and small companies lead the overall market by an additional three months. Both are right on schedule to predict an October turnaround.

The second of eight major benchmarks is housing, and that market appears to have hit some version of a bottom. For every homeowner sadly walking away from a foreclosure, there is someone else now ecstatic at being able to find an affordable home.

Retail sales are still falling and have yet to hit bottom, as is also true with the level of new orders and production of goods. This is why October is still the earliest we can safely say that the economy will have entered its recovery stage. Retail sales need to start an upward trajectory before we have any serious resurgence, and this category generally lags the housing and financial indicators by several months. Prices will continue to fall for several more months, and then start rising sometime in mid-2010. The consensus is that the real force of the recovery will be felt in 2010, but the seeds will be planted as early as October of this year. We might as well start crossing off the days on our calendar.

Meanwhile, the trend research indicates that the stock market, for example, will not achieve its 2007 high water mark until as late as 2020. That's not to say that retirement savers won't make money between now and then. There will be dividends reinvested during the next 10 years and there will be market declines offering opportunities to dollar cost average. The latter reduce the average price of all shares by buying at least some on a regular basis while the market implodes. Anyone curious about inflation might be interested to know that it will be 1.5 percent in 2009; 3-4 percent in 2010; and 8 percent in 2011.

And that's not all. So far, only \$125 billion of the \$480 billion earmarked for the stimulus has been spent. The balance when disbursed will further strengthen 2010's economy. About the time the rest of the stimulus is paid out, the banks will be paying back the money we lent them. Is this a great country or what?



## Investing during stagflation

by Stephen J. Butler

Anyone lining up historical facts and then peering into the future can reasonably guess that inflation will define the economy for the coming generation. Under these circumstances, some investment shifts can make some sense, but first a look at the fundamentals.

Congress has three choices. They can raise taxes. They can cut programs and spending. Or, they can allow inflation to effectively reduce the value of the dollars that we owe to our own citizens and foreign governments that have bought U.S. Treasury bonds. The inconvenient truth about taking the inflation route is that no politician needs to take responsibility for a specific tax increase or spending cut. Inflation just creeps like fog onto the economic scene, allowing a "my hands are clean" approach to dealing with the problem. Meanwhile, just as the fog slows down sea traffic here at my Maine coast vacation site, inflation caused by rising interest rates slows down the economy like throwing out an anchor.

We're talking "stagflation" which is inflation coupled with a struggling economy.

It doesn't take much cynicism to conclude that inflation will be the path of minimum regret for Congress in the years ahead. The economic prognosticators at the highly-respected Institute of Trend Research have predicted inflation ramping up to 8 percent within three years.

When it comes to investing in an inflationary environment, housing comes immediately to mind. This was confirmed in a personal discussion with a Bay Area homebuilder hit especially hard by the housing implosion.

He said, "Inflation has always been great for the housing industry."

With the housing market having hit bottom, coupled with the fact that we have historically low, fixed-mortgage rates, an investment in housing can make great sense today. Vacation homes with views or on the water, and residences in urban areas, tend to benefit the most from long-term inflationary conditions.

With respect to fixed-income investments, bond mutual funds with longer average maturities will always be trying to catch up with inflation. Capital values of existing bonds in the fund will drop until they begin to approach maturity. If the majority of the bonds in the fund are several years away from maturity, the entire mutual fund's value will be depressed for awhile.

A short-term bond fund, by comparison, has bonds that mature in two or three years on average, and this is too short a time period for much drop in value. Another approach is to invest in individual bonds themselves instead of investing through a mutual fund. This enables you to control the maturity of each bond and hold them to maturity if they drop in value in the interim.

The stock market, during an inflationary period, tends to "whipsaw" investors. On the one hand, rising interest rates are bad for corporations that are paying for borrowed money. Interest rates, in general, are the single most important determinant of corporate profits. Meanwhile, companies typically own assets that can increase in dollar value and they can raise prices during an inflationary period. Buy-and-hold investors who are dollar-cost averaging, investing steadily, are served well in a whipsawing market. Those trying to time the market, without exception, will miss opportunity as the market climbs on its "wall of worry."

We went through this in the '70s, of course, but back then we didn't have any money. This time it's different, and we have to think about what inflation might mean to us.

