

C *Economic & Market* Commentary

Growth is not a four-letter word

For the last 18 months, the Federal Reserve Board (Fed) has steadily increased short-term interest rates in an effort to subdue price pressures. The publicized focus at the Fed has centered on a cause and effect relationship between economic growth, the resulting tight labor markets and the rate of inflation. Many economists and market watchers climbed aboard the “anti-growth” bandwagon. Concerns regarding the outcomes of Fed policy have held the markets hostage for the better part of the last nine months. As economic data and opinions have ebbed and flowed, benchmark interest rates and stock prices have moved accordingly. It has looked exciting, yet overall the markets have essentially gone sideways. Unless one enjoyed the right allocation, or successfully traded the fast moving markets, portfolio values have also gone sideways.

It is encouraging to hear members of the Fed begin to speak more positively about economic growth. For a while, our view that economic growth, in and of itself, did not lead to inflation was in the minority. We believed that the positive influences of economic growth, productivity growth (causing falling unit labor costs), reasonable capacity utilization rates and global competition would keep inflation in check. While the run-up in the price of oil and an active Fed made our stance more difficult at times, history does not support the conclusion that economic growth causes inflation. If anything, the facts support just the opposite...above average economic growth actually correlates with lower inflation rates. In our current environment, economic growth is the engine behind the projected budget surplus. These surpluses are the backbone for many economic and interest rate forecasts. Should economic growth slow too much, projected surpluses would vanish, as would any hope of further reducing the federal debt, shoring up social security and other spending programs, or cutting taxes. As mentioned in previous commentaries, the ramifications of too much slowing are far worse than too much growth. If the Fed’s bias has truly changed from an anti-growth sentiment, and its actions reflect this change, the consensus view regarding the economy should narrow and provide a more stable backdrop for the financial markets.

Over the years, our philosophy has been to invest for long-term appreciation and look past the short-term issues and events that cause day-to-day movement in stock prices. Short of modest adjustments to rebalance portfolios or take advantage of opportunities to reduce tax expenses, we have “stuck to our guns,” and see no reason to change our philosophy despite the current market volatility. As expected, the overpriced sectors of the stock market have corrected, and our asset allocation strategy has proven effective in reducing portfolio volatility and providing positive returns in a down market. As we head into fall, the markets continue to bounce around, but under a more positive economic outlook than earlier in the year, and for those of us in Arizona, the cooler weather is just around the corner.

Stephen J. Taddie
Principal