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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

The latest monthly data reveals that US exports are increasing at three times the rate of imports – year-on-year growth for exports was 14.8% while imports grew 5.1%.

The Euro reached a lifetime high against the dollar on the last trading day of the 3rd quarter – closing at $1.42.

Inflation Pressures and Expectations

On September 18, global stock markets reacted favorably to an unexpected half percent cut in the Fed Funds rate by the Federal Reserve Board. In times of high market volatility, the Fed gets a lot of attention in the popular press. In light of the high profile of the nation's central bank, this article will review inflation pressures and expectations.

There is much debate about the level of influence that the Federal Reserve exerts over the US economy. There is general acknowledgment, however, that the Fed wields considerable sway over short term interest rates. Last Tuesday, the bank signaled that it would make it easier for banks to lend to one another by reducing the target interest rate on Fed Funds. In short, it will inject money into the economy thereby reducing its price – interest rates. The Fed accomplishes this by buying treasury securities in the open market.

There are both benefits and risks to this strategy. Over the past two months, many fixed income markets have suffered a severe decline in liquidity. Affected markets include subprime mortgages and asset-backed commercial paper (ABCP). It is hoped that a more accommodating fed policy will stimulate trading and help prices recover. The size of the ABCP market has fallen 17% in the last two months. In the last 2 weeks, though, that decline has slowed to a trickle. After spiking in late July and August, interest rates have fallen back nearly to where they were before the crisis in lending.

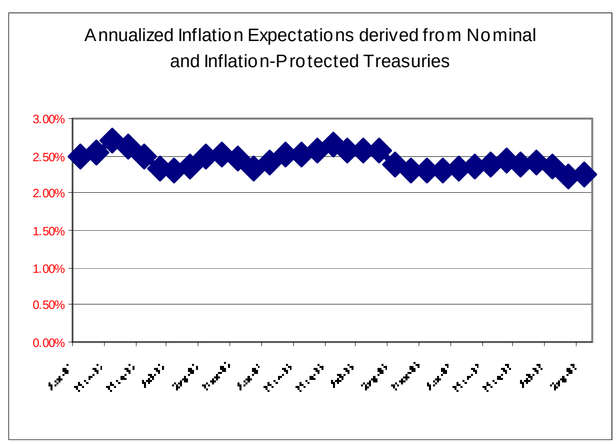
More money in the economy might also stimulate inflation. And one of the primary mandates of the Federal Reserve is to keep it under control. There are big risks out there.

Our country has been running substantial trade deficits with most of our trading partners. This places downward pressure on the dollar and, with it, upward pressure on the cost of imports. The dollar is down an average of 20% against other major currencies since 2002. The cost of imports has climbed as prices for key imports such as consumer goods, vehicles, and capital goods increased at their fastest rate since 1996.

The recent cut in the fed funds rate makes the yield on dollar denominated assets even less attractive to foreign investors. Moreover, looming deficits in both Medicare and Social Security present growing fiscal challenges. Emerging economies like China and India are competing directly with us for natural resources. As a result many basic commodities are subject to inflationary pressures. This is aggravated by weakness it the medium we use to purchase them - the dollar.

On the positive side, market and survey measures of future inflation have remained quiescent. The Survey of Professional Forecasters released last month indicated that the consensus estimate for core inflation had *fallen* in the past three months … to 2.2% annually from its May 2007 estimate of 2.3%.

Market based assessments of future inflation confirm the rather sanguine outlook of professional forecasters. The difference between the yields of nominal treasury notes and Inflation protected treasuries is viewed as a close approximation of future inflation expectations. The chart below reveals that the difference between nominal treasury yields and the real yields paid by inflation protected treasuries has been remarkably consistent at between 2.0% and 2.5%.



Most of the anecdotal examples of inflation in the recent past have focused on increases in energy prices – particularly gasoline. Energy and food prices have historically been excluded from measures of core inflation. Both items tend to

have volatile price histories often driven by external shocks such as weather incidents or political turmoil. The good news is that both realized headline and core inflation numbers have been low. The CPI increased 2.0% in the last 12 months while core inflation increased 2.1%. These figures are in line with the expected inflation estimates discussed earlier.

The implications for the American consumer are positive in the short run. Sustained price inflation has been absent from the US economy for nearly 25 years. This has occurred despite consistent and growing trade deficits. Over this same period, most major financial asset classes have generated returns that far surpassed inflation. As long as inflation remains in check, we can assume that diversified investment portfolios will continue to increase consumer buying power.

One area of the economy that has misbehaved relative to inflation is medical care. The article below will examine some rather alarming trends in the cost of health care for the nation's insured employees.

Cost of Health Care for the Nation's Employees

"The Survey of Professional Forecasters released last month indicated that the consensus estimated for core inflation had fallen in the past three months … to 2.2% annually from its May 2007 estimate of 2.3%. "

"Health insurance costs have outpaced inflation by nearly 2 to 1 since 1999."

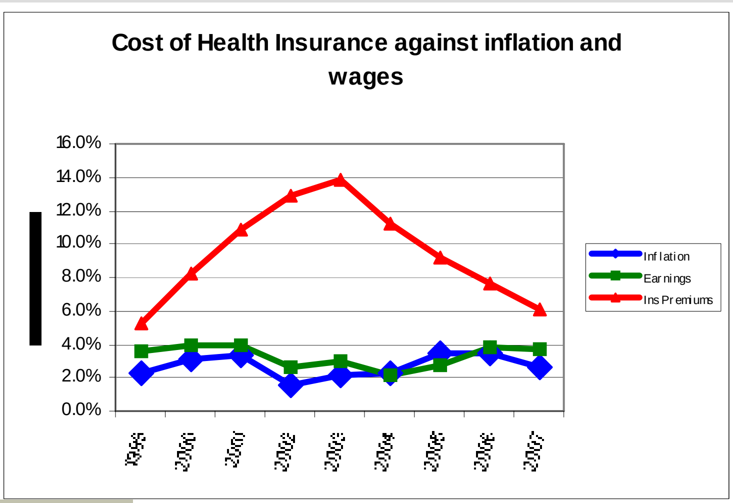
As a financial advisor, I often project client expenses to determine the amount of money they'll be able to accumulate for retirement. One of the most difficult areas to estimate is the cost of medical care. Historically, the cost of medical care has increased much faster than the CPI. In the 12 months ending August 2007, for example, medical expenditures increased 4.5% - more than twice the general inflation rate.

Recently, the Kaiser Family Foundation has released some useful survey information on the escalating cost of employer-provided health insurance. The cost of group insurance has increased even faster than overall medical care. Today, Employees' annual average cost for single coverage is $4,479 and $12,106 for family coverage. Single workers on average pay $694 of the cost out of their own pockets, while worker contributions for family coverage is $3,281.

As the chart illustrates, group health insurance price increases uniformly exceed inflation and wage growth for the nation's employers. In fact, health insurance costs have outpaced inflation by nearly 2 to 1 since 1999. If we project the same real increases in health insurance premiums over the next 8 years, the cost to insure a family will climb to $2000 per month in today's dollars! It is small wonder that many union/management disputes today are centered around health care benefits. Craig Barrett, chairman of Intel, warned "Health care is the Achilles heel of the US in terms of competitiveness".

Covered workers on average pay 16 percent of the overall premiums for single coverage and 28 percent for family coverage - figures that have remained relatively stable over the past years. However, high deductible health care plans constitute a progressively larger share of benefit options. Moreover, recent survey data indicates that cost sharing may shift further to the employee in the next year. 12% of employers say that they are "very likely" to increase deductibles, 13% saying that they are "very likely" to increase copayments and coinsurance, and 11% saying that they are "very likely" to increase the amount that employees pay for prescription drugs.

There is some evidence that smaller employers, with fewer than 200 workers, are exiting the group health insurance market. The fraction of small companies providing health insurance has fallen from 65% to 59% since 1999.



Retiree health benefits are an important consideration for older workers. Unfortunately, the scope of such coverage has contracted in the last 20 years. In 1988, 66% of all large firms offered retiree health care. That fraction has halved to 33% today. As these benefits are not vested like pensions, the prospect for further erosion is high. With this statistical backdrop, it's easy to appreciate the difficulty in modeling health care expenditures for clients eyeing retirement. My view is to budget some reasonable amount to provide a margin of safety.