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Financial & Retirement Planning for Life

Mid-Year Outlook: Slow Growth, Higher Inflation – Or Both

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U.S. economic growth continues at a subpar pace, with the housing correction and tighter mortgage credit contributing to a steep decline in home prices. Credit market conditions have improved, but rising oil prices exacerbate the situation, generating increased downside risks to growth and upside risks to inflation. Not a pretty picture, but hardly a disaster. Federal Open Market Committee rate cuts should help support growth

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The High Price of Low Risk

When markets turn volatile, when returns approach zero or occasionally dip into the red, it's not uncommon for investors to worry about their carefully constructed portfolios and consider realigning them with the most stable investments – those that seem to carry the least risk. It's an understandable temptation, but one to be resisted.

Risk is like the air in your tire. Reduce it to almost nothing and the tire may still roll, but you're not likely to reach your destination in time, and you face the possibility that your tire will start shredding before you get very far. The good news is, whatever happens, you won't need to worry about excessive speed.

In financial terms, putting your faith entirely in the lowest-risk investments can undermine your portfolio, whether your goals stretch toward retirement or are set on nearer-term objectives. The good news is you probably won't actually lose money.

Cost of Security

Low-risk alternatives abound: savings accounts, certificates of deposit, money market funds. True, they are safer places to store your cash than stuffing it under

your mattress, but you can forget substantial financial gains.

Consider these figures from an Ibbotson Associates study of average annual returns during the 20-year period from 1986 through 2005: money market funds, 4.74%; U.S. stocks, 11.93%; international stocks, 10%; real estate, 9.88%; international bonds, 8.74%; and U.S. bonds, 7.93%. Although such figures illustrate past performance that does not indicate future performance, the message is clear: over time, real gains come from the riskier investments.

During this 20-year period, the average annual inflation rate was 3.03%,* so the average money market investor would have kept slightly ahead of inflation. Those investing for real financial growth, however, were lost unless they had stayed invested in somewhat riskier stocks and bonds. That would have meant riding through the market crash in October 1987, the Asian financial crisis of 1997, the dot-com bubble burst in March 2000, and the recessions of 1990 to 1991 and 2001 to 2003. But portfolios of U.S. or international stocks would have gained more than 10% annually, and even bond

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*Source: Federal Reserve Bank of Minneapolis

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Mid-Year Outlook *(continued from front)*

into 2009, as it takes time for monetary policy to have an impact.

The weakened consumer outlook reflects a soft job market and slow growth in aggregate wage income, while higher food and energy costs reduce consumer purchasing power. Banks have tightened terms and standards for consumer loans, and it's more difficult for consumers to extract home equity to fuel spending. Economic stimulus payments issued in May and June provided some support, but only briefly.

Commodity price pressures are high, and a softer dollar has led to greater inflation in import prices. Some measures of inflation expectations have increased, but not terribly.

The Federal Reserve remains in a tough spot. The housing and credit market strains have been serious drags on growth, and the Fed has been

justified in lowering short-term interest rates to counter the effects. However, there's not much it can do to offset the economic drag from higher oil prices (cutting rates would accommodate higher inflation). Furthermore, the inflation fight is global. Other central banks are likely to raise rates, and the Fed risks contributing to a weaker dollar if it doesn't respond.

The rise in oil prices, if sustained, will lead to a number of significant economic adjustments. Consumer spending patterns are shifting. People will buy more fuel-efficient cars, car-pool more and take public transportation – and they will curb spending in other areas. Food and energy prices should stabilize, and inflation-adjusted wage growth will eventually pick up. However, growth and inflation worries are likely to trouble the financial markets in the near term. ■

High Price *(continued from front)*

investors would have gained nearly 8% annually – far outpacing inflation.

Inflation's Toll

In a sense, financial success depends on subduing inflation. If just keeping up is your objective, low-risk investments might do the trick. But if you have loftier goals, a totally low-risk portfolio is unlikely to produce what you want.

Studies have shown that well-diversified portfolios – carefully chosen mixes of risky and less-risky investments – can help reduce volatility while delivering decent performance over the long term. Ibbotson's 20-year study showed a well-diversified portfolio returning an average annual return of 9.46%. That's the kind of return that can help propel your portfolio toward its goal.

If you have questions about your portfolio's make-up, please don't hesitate to call me. ■

Financial Planning:

Sliding Along the Movable Risk Tolerance Scale

Just as dieters' devotion to weight loss may be tested when appealing but calorie-laden meals are set before them, the accuracy of an investor's self-assessed market risk tolerance level comes under scrutiny when markets turn volatile. Such a test has been under way at least since the summer of 2007. How has your stated risk tolerance stood up to reality?

Many investors, comfortable with the

level of risk they envision when asked the question in a quiet office setting, have discovered that risk tolerance is a many-headed concept, subject to constant change as market indexes race up and down the charts. The fact is, you may not have a consistent risk tolerance quotient.

Your appetite for risk may not be entirely independent of current markets, it turns out. Research into investor

psychology indicates that for many, greater risk tolerance tends to coincide with positive market movements, as when the market climbed to new highs in October 2007. Less risk-tolerant attitudes emerge in more turbulent times, which so far have characterized 2008.

There is no cure for risk tolerance anxiety. The only agreed-upon antidote is to focus on long-term goals and stick to your plan. ■