

## **Inflation fears rising**

July 1, 2008. The record price of oil was topic number one through much of the second quarter of the year. Gasoline at \$4 per gallon and more hit American automakers hard, as sales of SUVs plummeted. The crucial questions: How long until higher energy prices ripple through the rest of the economy, and how big will the impact be?

Food prices are equally problematic. The flooding in Iowa washed away a significant portion of this year's corn crop, so much so that the Agriculture Department forecast that 9% fewer acres of corn will be harvested this year than last. The shortfall comes just as demand from ethanol manufacturers for corn has bid up prices as well. The end result could be increasing costs right through the food chain.

Inflation dangers need to be balanced against the continuing general economic weakness, especially in the housing sector. A year ago, when the federal funds rate stood at 5.25%, the Federal Reserve Board began a series of interest rate cuts to ward off recession. That process ended in June, when the Fed left the short-term rate unchanged at 2%.

Was that effort successful? Although some commentators have been claiming that we've been in a recession for six months and more, the fact is that through the end of the first quarter, the economy had not yet contracted. The verdict on the second quarter is still out at this writing, but several indicators, such as the survey of the National Association of Purchasing Managers, were still showing weak growth in June.

Could we be on the verge of an inflationary spiral, as happened in the 1970s? Some economists consider such a development unlikely at this time, because workers lack the bargaining power to push up wages, the next step in the spiral.

### ***Housing remains in the doldrums***

Sales of existing homes were up 2.0% in May, the largest month-to-month increase since February. That good news might be interpreted to mean that the housing market is beginning to bottom out, that property values have stabilized. Unfortunately, some portion of the increase is attributable to record levels of foreclosures. New home sales remain down roughly 40% from year-ago levels. The housing sector won't be out of the woods until new home sales begin to recover.

### ***The global economy***

Stocks had a poor second quarter. The Dow Jones Industrial Average lost 7.4% and is very close to being 20% off its previous high, set in October 2007. That's the commonly used benchmark of a bear market. In fact, the Dow was in bear territory in intraday trading on each of the last two sessions of the quarter. It was the third consecutive quarterly decline for the index, the worst second quarter since 2002.

Other market indices were only slightly better. The S&P 500 was down 3.2% for the period, while the NASDAQ Composite closed up 0.6%. If the economy improves, this would be a buying opportunity for stocks, but that is a big if.

Where has stronger economic growth been found in recent years? In the developing economies.

In 1996 the U.S. was home to 203 of the 500 largest companies in the world, according to the Financial Times newspaper. Japan was second, with 110. The picture today is quite different, as the U.S. share has fallen to 169 and Japan's to just 39. In 1996 neither India nor China had a single company in the top 500. Now India has 13, and China has 25. Other countries moving up the ladder by this measure include France, Russia, Spain and Brazil.

Investing outside the U.S. brings with it new sets of risks, however. Many countries lack the regulatory oversight that governs U.S. securities markets, for example. Currency changes add a new dimension to the risk/reward tradeoff.

One approach for reducing these risks is to invest in mutual funds that invest globally, to get the benefit of diversification and professional investment management. Another is to invest in those foreign companies that also trade on U.S. exchanges. But one also can get exposure to the global economy by investing in the many U.S. companies that derive a significant portion of their revenue from foreign operations.

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