WELLS FARGO

QUICK MARKET UPDATE

Panic of Last Week: Growth, Panic of This Week: Inflation

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Last week, the U.S. equity markets took a hit as traders were worried about growth. The unemployment rate rose to 5.5%, primarily because of an increase in teenagers looking for work. Forget the facts that job losses were much less than economists projected and teenagers are a very small part of the economic force. The concern was that the rise in unemployment meant that consumers were not earning money and the U.S. economy would suffer.

What a difference a week makes.

This week, the concern is inflation. We are seeing oil, gasoline and food prices rising, putting consumers in a bad mood. Today we saw a rise in the rate of the headline consumer price index (CPI) to 4.2%. Even core inflation—inflation less the more volatile oil and food components that is the more widely used gauge in setting interest rates—has risen from a very low 1% a few years ago to close to 2.3% today. When core CPI was at 1%, the handwringers were obsessed with deflation; now the concern has swung to the other extreme.

Let's put this into perspective. Yes, a 4.2% inflation rate is on the high side, but it is far from the double-digit inflation experienced in the 1970s. While we see gasoline and food prices on a daily basis, they are not the biggest components of CPI. Housing costs and wage increases have the largest impact on inflation. With housing prices falling and wage growth very low, this takes some pressure off of inflation.

This past week, many global central bankers have been flexing their muscles as inflation fighters. The Canadian Central Bank held interest rates steady, despite an anticipated rate cut, with inflation overshadowing growth concerns. The European Central Bank and U.S. Federal Reserve have been talking tough in advance of future rate decisions. Emerging economies with very high inflation rates are taking action, with currency rate adjustments and monetary tightening. This tough talk helps to reduce "inflationary expectations" which can become a self-fulfilling prophecy. If people think inflation is going up, they will include that into contracts, wage negotiations and pricing policy, hence spurring inflation. The recent actions have been designed to reduce inflationary expectations.

The concern about fighting inflation is that it requires a rise in interest rates. Climbing rates make money expensive, reducing capital to the markets, hence reducing profits, growth and valuations. Such a scenario is not good, but let's also put this into perspective. Interest rates today are very low. The Fed funds at 2%, 2-year Treasury at near 3% and 10-year Treasuries slightly above 4% are accommodative to growth. An increase in the federal funds rate from 2% is moving towards a more "normal" rate, and not overly restrictive.

In addition, a key contributor to inflationary pressure has been the declining dollar. Recently, the price of oil and the value of the dollar have been very negatively correlated, meaning when one goes up, the other goes down. An increase in domestic interest rates makes the dollar more attractive, which can help stabilize the value of the dollar on global currency markets. A falling dollar also imports inflation into our economy, as foreign goods imported for consumption become more expensive. An increase in rates can help reverse this inflationary cycle.

We do not want to minimize the pain of paying over $4 per gallon at the pump or over $4 for a gallon of milk. We are encouraged that central bankers are acknowledging the inflationary pressures that we have been talking about since late last year. The actions required are reasonable, and not dire, to economic growth and prosperity. The equity market is in a very emotional state. Each day, people overanalyze and overreact to some piece of economic data. We keep our eyes on the horizon and see attractive valuations, improving productivity, good earnings growth and global opportunities. Our asset allocation strategy reflects this, as we encourage investors to put cash to work, diversify globally, use alternatives to control risk and provide growth opportunity, and keep your asset allocation focused on your goals and not on the moods of Wall Street.

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