



Dunn Warren Investment Advisors

The Portfolio Reporter

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Interest Rates and the Stock Market

Sometimes, especially in the investment world, bad news is good news, and in the past month, there has been mounting evidence that bad news for the unemployed may actually be good news for inflation.

This relationship seemed to be confirmed by Federal Reserve Chairman Ben Bernanke who testified before Congress in the last week of February that inflation is nowhere in sight, and he projected that consumer prices would rise at a modest rate of 1 to 2% annually through at least 2012. In that same testimony, he called unemployment “the biggest problem we have.” Linking the good news on inflation to the bad news for the jobless, he noted that high unemployment will probably persist in the coming years and with low inflation, the Fed will be able to keep interest rates low.

More bad news for the unemployed is that relatively few businesses seem to be hiring. The January unemployment report issued by the Bureau of Labor Statistics indicated that 10.8 million people were unemployed and actively looking for a job. The Conference Board *Help Wanted OnLine*TM index counted less than 4 million want ads in February, meaning that there were an average 3.7 unemployed persons competing for each advertised vacancy. As recently as the spring of 2008, there were more employment ads than unemployed workers. With unemployment so high, employers have little incentive to increase wages to attract potential workers. Until this situation reverses, we do not expect wage growth to be significant, and we expect that to be a factor which holds down inflation.

On the surface, low inflation and low interest rates should be good news for stocks. Generally, the stock market is viewed as alternative to an investment in bonds, and low interest rates make stocks more attractive. While there are many other factors that drive the general trend in stock prices, stocks do tend to do better when interest rates are low or declining. As an example, the Fed Funds rate, a short term interest rate controlled by the Federal Reserve, fell from 15% in 1982 to 6% at the time of the stock market peak in 2000. Over that time span, stocks enjoyed a great bull market and the S&P 500 delivered average annual gains of more than 18%.

The broader question is whether we can have higher interest rates without inflation. Since the interest rate is really just the price someone pays to borrow money, the laws of supply and demand should ultimately govern the level of interest rates. There is no question that the supply of new debt is projected to be extremely large for the next few years. The Congressional Budget Office forecasts a government deficit of more than \$1.3 trillion for the fiscal year ending in September of this year, and trillion dollar deficits for at least several years after that. Our government is not alone in their quest for money. The International Monetary Fund estimates that other countries will be looking to raise an additional \$3.2 trillion this year.

Basic economic theory holds that as the supply of an item increases, its price should fall. There is no question that the supply of bonds appears to be increasing - total issuance by world governments amounted to an average of \$1.5 trillion a year over the past five years, one third of the supply projected for this year. If the laws of supply and demand really do apply to bonds, then the interest rate payable on bonds will rise as prices fall.

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Rising rates could be bearish for the stock market. Many investors are still shell shocked from the recent bear market. Higher yields from bonds, which pay a steady coupon rate usually every six months, might be an appealing alternative to the volatility of the stock market. The uncertain interest rate environment is only one factor that concerns us about the stock market. But we do think this is important to watch, and to be prepared to act upon as the global situation warrants.

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MONTHLY CONFERENCE CALL

Our next monthly conference call will occur Thursday, March 18th at 11 a.m. Mountain Time (1 p.m. EST).

Phone Number: 866-740-1260

Access Code: 4682824

To view slides on the internet during the call, go to www.readytalk.com and enter 4682824 under "Join a Meeting".

Please Note: If you would like to receive free monthly **emails** of this newsletter, along with **links to hear our monthly conference call**, you can sign up on our website.

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Thank you for your time.