SOCIETY FOR FINANCIAL EDUCATION AND PROFESSIONAL DEVELOPMENT
Enhancing financial and professional growth...

1325 G Street NW, Suite 500
Washington, DC 20005
(202) 842-3807 • (301) 203-0289 Fax
www.sfepd.org

financial $UCCESS

FEBRUARY 2008

Will Low Inflation Continue?

Since the mid-1980s, inflation has been much lower and more stable than it was in the past. The high inflation rates of the 1970s detracted from the country's standard of living, hindered capital formation and economic growth, and it took the country many years to overcome the adverse effects. It is now generally believed that maintaining a low and stable inflation rate provides lasting benefits to the economy, which is why it is one of the Federal Reserve's primary monetary policy goals. As detailed in the 1977 amendment to the Federal Reserve Act of 1913, the Federal Reserve's goals when setting monetary policy are "to promote maximum sustainable output and employment and to promote stable prices."

In recent years, inflation has changed in a number of ways:

✔ Movements in inflation now convey less about future inflation. In the late 1970s and early 1980s, the most accurate forecast of future inflation was an average of inflation over the past few quarters. Sharp increases in inflation took a long time to reverse. Since the mid-1980s, shocks to inflation have not lasted long. Thus, the best estimate of future inflation is a very long average of past inflation.

✔ The correlation between inflation and unemployment has decreased. In the 1960s and 1970s, inflation tended to rise in periods when unemployment was low and vice versa. Starting in the 1980s, this correlation weakened substantially. Thus, a rapidly expanding economy will tend to generate a smaller increase in inflation. However, once inflation increases, it will be more difficult to get it under control, since the economy will have to slow more to reduce inflation.

✔ Changes in energy prices have less impact on inflation. In the 1970s, increases in energy prices had a significant impact on core inflation, which is the change in consumer prices excluding food and energy. Since the early 1980s, energy price changes have had little impact on core inflation.

✔ Economic volatility has decreased significantly in the

Continued on page 3

Job Stability in America

The most common measure of job stability is job tenure, or the length of time a person holds a job. Based on U.S. Bureau of Labor Statistics (BLS) data from 1983 to 2006, job tenure was essentially unchanged for men and increased for women. However, when that data was broken down by age groups, job tenure for women between the ages of 35 and 54 rose by about six months, while job tenure for men between the same ages fell substantially. For instance, job tenure for men between the ages of 45 and 54 fell approximately 37%, from 12.8 years in 1983 to 8.1 years in 2006.

BLS data also suggests that there has been an increase in the level of involuntary job loss. Not only does this result in lost wages while the worker is looking for a new job, but often a new job pays less than the former job. From 2001 to 2003, workers experienced a 17% decline in earnings due to job displacement. Individuals with at least a college education experienced the highest level of lost wages, down 21% on average. Other consequences of job loss include losing health insurance benefits and not accumulating funds for retirement. ❍❍❍

FR2007-0827-0140

The Basics of Earnings

From an accounting standpoint, earnings are calculated by subtracting operating costs, taxes, and preferred stock dividends from revenue. Those earnings are typically divided by common stock shares outstanding to come up with earnings per share, or EPS. EPS is a convenient way to compare earnings over a period of years, so upward or downward trends can be identified.

The price/earnings ratio, or P/E ratio, is calculated by dividing the stock's price by its EPS. It's one of the most common measures of stock value, both for individual stocks and the overall market. It basically indicates how much investors are willing to pay for a dollar of the company's earnings.

For individual companies, investors' expectations regarding future earnings affect the P/E ratio. Confidence that a company will improve its profitability or remain profitable generally results in a higher P/E ratio. If profits are threatened or weak, the P/E ratio is likely to drop. P/E ratios for the overall market change based on broad market conditions and investors' views about how desirable stocks are compared to other investments.

A company's growth prospects can be evaluated using the price/earnings growth, or PEG, ratio, which is calculated by dividing the P/E ratio by the company's projected earnings growth rate. A PEG ratio of one is considered standard, meaning its growth rate is incorporated in the stock's price. A PEG ratio higher than one means the stock is trading at a premium to its growth rate, while a ratio less than one may mean the stock is undervalued. ❍❍❍

What Is Happening to Long-Term Interest Rates?

Typically, when the Federal Open Market Committee (FOMC) raises the federal funds rate, long-term interest rates react by increasing also. However, between June 2004 and July 2006, the FOMC raised rates 17 times in 1/4 percent increments, from 1% to 5.25%, and long-term rates barely moved.

In the past, a 1% increase in the fed funds rate produced a 0.3% increase in the 10-year Treasury yield (Source: *Economic Letter*, September 2006). Thus, with a 4.25% increase in the fed funds rate, you would expect the 10-year Treasury yield to increase by 1.3%, but it only increased 0.3%.

Similarly, since 1980, the difference between the yield on 3-month Treasury bills and 10-year Treasury notes has averaged 1.79% (Source: The Federal Reserve Board, June 16, 2006). As recently as the end of 2006, the difference was less than 0.5%. Currently, the difference is still only 0.8% (Source: *Federal Reserve Statistical Release*, November 26, 2007).

Why haven't long-term interest rates increased as expected? Returns on bonds have two components — the real component, which compensates investors for the risk of loaning money, and the inflation component, which compensates investors for expected inflation over the bond's term. In recent years, both components have been trending downward:

✔ **Real component** — The real component is also called the term premium, since historically investors have received a premium for increasing the term the bond is held. Since the mid-1980s, economic growth has been less volatile, making investors more confident about future economic stability, so they require less return to hold longer-term bonds. It is also believed that demand for long-term bonds has increased, while supply has not kept pace, bringing down returns.

✔ **Inflation component** — Compared to a 5% inflation rate from 1980 to 1999, inflation in industrialized countries averaged 2% from 2000 to 2004 (Source: The Federal Reserve Board, June 16, 2006). Not only has inflation decreased, expectations for long-term inflation are in the 2% range. This has put significant downward pressure on long-term interest rates.

The behavior of long-term interest rates is not unique to the United States — other countries around the world have experienced similar declining patterns. The trend is so widespread that globalization of trade is suspected to be a major factor. Since goods, services, money, and ideas can cross borders so easily now, economies in different countries are tied together more closely. Excess demand in one part of the world can be filled by excess supply in another part of the world, evening out economic activity in individual countries.

This has major implications for monetary policy. Central bankers have control over short-term rates, which is the primary means of implementing monetary policy. Typically, when short-term rates are increased, long-term rates follow. Higher long-term rates reduce consumption and investment, which helps contain inflation. Reducing short-term rates typically reduces long-term rates, which increases economic activity. If those relationships no longer hold, monetary policy will be significantly impacted. ❍❍❍

Low Inflation

Continued from page 1

United States. Since the mid-1980s, output growth has been 50% less volatile and employment growth has been two-thirds less volatile than the previous three decades (Source: *Business Review*, Quarter 1, 2007). Inflation's volatility has also fallen substantially.

Inflation expectations significantly influence actual inflation. Long-term inflation expectations vary over time, depending on economic developments and current and past monetary policy. U.S. monetary policy has become much more focused on low inflation, and the Federal Reserve has been strongly committed to keeping inflation under control. During the 1980s and 1990s, the Federal Reserve brought inflation down from double-digit levels to approximately 2%, a level that has been maintained for the past decade.

The Federal Reserve has done such a good job that expectations about future inflation have moderated significantly in recent years. Thus, when there is a shock to inflation, the public believes that the Federal Reserve will control the situation, so expectations about future inflation do not change much, keeping inflation under control. A recent example is the substantial increase in oil prices, which has not led to increased inflation or a recession, as it did in the 1970s.

Will low inflation persist for the foreseeable future? Like all questions about the future, this cannot be easily answered. Inflation now reacts less persistently to shocks, which is a result of better monetary policy and inflation expectations. But these circumstances will only last as long as monetary policy meets the public's expectations. Long-run inflation expectations must be monitored closely, and the Federal Reserve must respond aggressively to inflation shocks. ❍❍❍

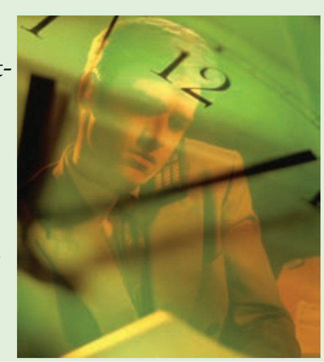
Working toward Your Financial Goals

To help pursue your financial goals, you need a plan to help you get there. These five basic tips can help:

✔ **Set exciting goals.** Putting money aside for a distant goal, rather than spending that money now, is a difficult thing for most people to do. To make it easier, set exciting goals that will motivate you to pursue them. For instance, rather than "saving for retirement," make your goal "to retire at age 60 with $1,000,000 in investments so I can travel and golf." Then quantify your ultimate goal and interim goals, so you'll have a way to track your progress.

✔ **Consult with a financial advisor.** The number of decisions that must be made to help ensure you meet your financial goals can seem overwhelming. Even if you have a basic grasp of some financial areas, you may be unfamiliar with other areas. A financial advisor can help coordinate your entire plan, making sure all financial areas are adequately considered. A financial advisor can also monitor your progress. Sometimes you feel more committed to goals when you know someone else is also watching your progress.

✔ **Determine the financial issues that are causing you problems.** Almost everyone has difficulty coming to grips with some aspect of their financial life. Perhaps your credit card debt is becoming burdensome, making it difficult to find money to save. Maybe you don't understand investing basics and have left your money in a low interest-bearing savings account. Or you may have totally ignored estate planning, leaving your spouse and children at financial risk if you die. Whatever area is causing problems, resolve to make strides in overcoming it this year.



✔ **Spend less than you earn.** The amount of money left over for saving is a direct result of your lifestyle. Your lifestyle decisions will impact you now and in the future, since you will typically want a similar lifestyle after retirement. To get a grip on your spending, take time to analyze your expenses and to set a budget. Try reducing nonessential expenditures, such as entertaining, dining out, and vacations. Another strategy is to find ways to spend less for the same things. For instance, obtain car insurance quotes from several companies, placing any premium reductions in savings.

✔ **Save it before you see it.** If you have to find money to save every month, you'll likely find there isn't much left after all the bills are paid. Typically, a better strategy is to set up an automatic savings program where money is automatically deducted from your bank account every month and deposited directly in an investment account. Another good alternative is to sign up for your company's 401(k) plan, having funds withdrawn every paycheck. Try to save at least 10% of your gross income. *(Remember that an automatic investing plan, such as dollar cost averaging, does not assure a profit or protect against loss in declining markets. Since such a strategy involves periodic investment, consider your financial ability and willingness to continue purchases through periods of low price levels.)*

If you'd like to discuss these tips or others to help you pursue your financial goals, please call. ❍❍❍

Declining Health Insurance Coverage

From 2000 to 2005, the number of people without health insurance coverage rose by almost 20%, for a total of 46.6 million Americans (Source: New England Public Policy Center at the Federal Reserve Bank of Boston, March 2007).

More than half of the uninsured were between the ages of 19 and 44. Almost 25% of individuals between the ages of 25 and 34 and 20% of individuals between the ages of 35 and 44 were uninsured. On the other hand, 95% of those age 65 and older have health insurance coverage through Medicare.

While a lack of health insurance is commonly considered a low-income problem, one third of the uninsured were middle class, earning incomes above the median household income in 2005.

Between 2000 and 2005, the percentage of Americans covered by health insurance decreased from 64% to 60%. During the same time period, public and private employers offering health insurance declined from 69% to 60%. This drop is primarily attributed to a shift in employment from manufacturing to services, which is more likely to have few employees and to not offer health insurance. In 2003, only 36% of businesses with fewer than 10 employees offered health insurance, compared to almost all firms with more than 200 employees. Additionally, many firms now use contractual or temporary workers, who are not eligible for health insurance benefits.

While individuals can purchase private health insurance, those premiums tend to be substantially higher than large businesses pay. Thus, many individuals without insurance coverage at work cannot afford to purchase health insurance on their own. ❍❍❍

Oil and the U.S. Trade Deficit

Since 1992, the United States has been incurring significant trade deficits, which occur when a country imports more than it exports. What impact has increasing oil prices had on the U.S. trade deficit?

Higher oil prices, which increased the cost of oil imports, accounted for over 50% of the increase in the U.S. trade deficit from 2002 to 2006 and 80% of the increase over the past two years (Source: *FRBSF Economic Letter*, September 22, 2006).

Typically, when prices increase dramatically, demand for that product decreases. However, oil imports have remained relatively constant despite significantly higher prices. Oil imports are fairly slow to respond to price increases because, in addition to the need for oil to run automobiles, so much of our manufacturing production in industries such as transportation and energy use oil. Airplanes, trucks, and power plants are fueled with oil, and it takes a relatively long time to find alternative energy sources. ❍❍❍

Financial Thoughts

International sales of U.S.-based companies increased at an annual rate of 16.4% for the first quarter of 2007, compared to 2.7% growth in domestic sales. International profits account for 25% of all profits of U.S. companies, up from 5% in the 1960s (Source: U.S. Commerce Department, 2007).

In a recent survey of financial executives, 81% indicated that their employee medical expenses had increased from 5% to more than 20% in the past year. Approximately 25% indicated that some or most of these increased costs would be passed on to their employees (Source: American Institute of Certified Public Accountants, 2008).

In 2005, 83% of families with multiple adults and one or more children were offered health insurance, compared with 81% of families with multiple adults and no children, 69% of households with one adult and no children, and 67% of families with one adult and one or more children (Source: Henry J. Kaiser Family Foundation, 2007).

When asked whether saving for college or retirement was more important, 43% of respondents indicated college while an additional 43% said retirement (Source: *InvestmentNews*, 2007). ❍❍❍