



# DAVID R. KERN

**ASSET MANAGEMENT**  
*Dynamic Asset Allocation Strategies*

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## 1st Quarter 2007 Newsletter

### Inflation's Impact

Inflation is the way in which the general level of prices for goods and services is rising. This means that the purchasing power of your dollar is falling. Inflation, along with taxes, is one of the reasons it is difficult to build wealth over time. Unmanaged inflation over time can devastate an economy, or a country. The primary business of the Federal Reserve Open Market Committee is to manage the rate of inflation in the economy. The Federal Reserve has two tools to manage this problem. The basic tool is the rate of overnight interest rates, and the other is the publication of their comments as a result of their meetings. These announcements can cause short-term reactions in the equity and bond markets, and their words are dissected for meaning.

In the most recent Federal Reserve Open Market Committee meeting, they “decided today to keep the target rate for Fed funds at 5.25%. Recent indicators have been mixed and the adjustment in the housing sector is ongoing. Nevertheless, the economy seems likely to continue to expand at a moderate pace over coming quarters. Recent reading in core inflation has been somewhat elevated. Although inflation pressure seemed likely to moderate over time, the high level of resource utilization had the potential to sustain those pressures. In these circumstances, the committee’s predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the evolution of the outlook for both inflation and economic growth, as implied by incoming information”.

The continued demand for goods and services is growing around the world, and while oil prices have been essentially flat over the last year, they are at a much higher level than they were just a few years ago. The world economy is projected to grow 4.9% in 2007, more than twice the 2.2% growth rate anticipated for the United States.

China’s economy is forecasted to expand 10% in 2007 while India’s growth has been estimated at 8.4%. (Source: International Monetary Fund). This growth is reflected in the Federal Reserve’s comment that the high level of resource utilization had potential to sustain inflation. The Fed’s other major concern is a slowing economy, which without inflationary pressures, would cause the Fed to lower interest rates. The Fed refers to the adjustment of the housing sector, which means that interest rates have increased to cut off speculation in the fast growing areas of the country, and that a record number of mortgage defaults are expected in this tightening cycle. According to the National Association of Realtors, 45% of the first-time homebuyers in 2006 purchased a home with no money down. Consumers have taken on a record level of credit card debt as card limits have increased, and have ongoing confidence that easy money will always be available through refinancing. Auto loans could pose even a larger concern among lenders than the housing market, as companies have become more creative in finding ways to finance consumer demand.

The Federal Reserve policy makers are not alone, as inflation becomes a primary concern among central banks. Not only here in the U.S., but the European central banks will continue to raise rates. The Bank of Japan has signaled that it intends to keep raising rates, and China recently raised rates again.

The impact of inflation can be understood best with examples. BNT Research provides us with an example where \$1,000,000.00 will pay out a fixed amount of \$6,000 per month for 28 years and seven months, assuming the principal can earn 6% annually. If the \$6,000 monthly payment is increased each year to account for the impact of inflation, the original \$1,000,000.00 will last only 18 years and two months. While 28 years may cover a retiree’s life expectancy, most people can expect to live well beyond 18 years after retirement.

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**David R. Kern, Registered Principal**

The mathematical calculation ignores the ultimate impact of taxes on the account, which are due upon withdrawal from qualified accounts. This example is for illustration purposes only and is not intended to reflect any specific investment or performance.

### **Inflation Impact on the Markets**

Investment returns should be conditioned by the rate of inflation, and ultimate tax impact in order to understand net return. Market cycles can take many years to play out, and a look at historical relationships between inflation and the stock market offers some surprising conclusions. From the market bottom in July 1982 to the end of 1999, about 17 ½ years, the Dow Jones Industrial average produced and annualized a compounded rate of return of about 16% per year. That outsized return includes the stock market crash in 1987, the Gulf War, the collapse of the U.S. Savings and Loan systems, and other world wide short-term catastrophes. During this period, the consumer price index dropped from roughly 10% to about 2%. This drop allowed corporations to experience excellent profit growth, and also allow price/earnings ratios to expand from about 9 to 42.

In the period preceding this tremendous market gain, the period from 1966 to 1982, about 16 years, the major stock indexes ended basically flat, while roller coaster 20% rallies and 20% declines were experienced. During that period, the consumer price index started at 2% in 1965, and ended at 10% in 1981. The starting price/earnings ratio was about 20 and ended at 9.

Today's inflation numbers are slightly higher than the Fed's 3% comfort level. Price/earnings ratios are higher than you'd expect to see at the beginning of a new bull market. These are the concerns that we address with our active management programs, and our focus on risk management by reducing exposure to volatile markets.

### **Credit Expansion**

The Fed funds target rate, currently at 5.25%, was less than 3% from October 2001 to May 2005. Since that time, rates have risen as fear of inflation replaced deflation fears. The New York Times observed that, while the Fed was ostensibly pursuing a tight money policy on the one hand, it was actively flooding the market with liquidity at the same time, as indicated by the accelerated growth of the standard measures of money and credit. Yet the Fed was innocent of inconsistent behavior since it abandoned the goal of directing money growth.

Local banks are the ones that first create the money, mainly by issuing lines of credit to their customers. The Federal Reserve's trading desk underwrites those commitments by pumping federal funds into the system. By targeting the interest rate on federal funds, which are immediately available reserve balances held by member banks, it sets the price of credit. Once the price is set, it fully satisfies the demand for money. Gene Epstein, in his column "Growth Will Survive Fed's Best Effort"; March 2007 Barron's says, "As part of this insidious process, liquidity continually ends up in the wrong hands. During the late 1990s, for example, the target on Fed funds averaged higher than 5%, and yet that proved low enough to pump an asset bubble in the stock market that ultimately did bring a recession". Gene believes that strong consumer fundamentals of income and job growth could take up the slack caused by the sub-prime loans default rate which could impact many areas of the economy.

Included with this first quarter 2007 newsletter are our privacy policy statement, business continuity planning statement, and your investment policy statement.

Please contact David R. Kern Asset Management if there are any changes in your financial situation or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to the management of your account. Our current disclosure statement is set forth on Part II of Form ADV and is available for your review upon request.