

KWAG March E-mail Update

Good afternoon. As we enter the final month of the quarter, there continue to be plenty of headlines to worry investors. Even so, stocks (both large and small caps) are up roughly 5% year-to-date as we write this. This is well above the average historical performance of stocks over a two-month period and seems to indicate that, while there are certainly some concerns, there are also plenty of reasons to be optimistic. This is largely because the world economy continues to grow and the economic outlook looking forward remains very good. So good, in fact, that the S&P 400 midcap index hit an all time high on February 18, with small caps closing within 2% of their all-time highs.

However, in spite of the continued growth, concerns remain. We'll touch on a number of these issues in the upcoming quarter-end newsletter, but in the limited space available here we want to focus on the one gathering the most media attention—Inflation.

The Issue

To be honest, the amount of criticism directed toward the Fed regarding inflation and monetary policy continues to surprise us. In fact, we were recently stunned to hear a number of media pundits and few politicians question the Fed's efforts on the inflation front. Specifically, they have asked how the Fed can claim fighting inflation is a primary goal when they've done nothing to address rising oil and food prices. What they failed to realize, however, is that in raising these questions all they've managed to do is demonstrate how little they know about economics, inflation, and monetary policy. As Mark Twain so eloquently put it, "It is better to keep your mouth closed and let people think you're a fool than to open it and remove all doubt."

Inflation 101

By way of an inflation primer (particularly in case any of the aforementioned find themselves reading this missive) there are two major types of inflation measures that are used by economists. The one cited most often in the press is measured

by the Consumer Price Index (CPI) and is often referred to as “headline inflation.” The other inflation measure, called “core inflation”, is not generally reported in the media but is far and away the most important inflation measure for policy makers. Core inflation is essentially headline inflation with certain volatile items like food and energy removed.

Re-examining Inflation

Anyone familiar with monetary policy knows that the Federal Reserve focuses primarily on core inflation, since they have more control over this variable. This might seem odd to those not familiar with Fed policy, because food and energy clearly account for a large portion of the average American’s monthly expenditures. However, food and energy prices are often driven by external factors like “supply shocks”, which are well beyond the reach of the Fed’s (or anyone else’s) control. In essence, inflation can be split into two parts. First, there is a type of inflation that is driven by increased economic activity. This is known as “demand driven” inflation. And then there is “supply shock” inflation which is driven by external factors.

Today’s Inflation: Supply Shocks

Today, the biggest inflationary fears are currently concentrated in food and energy and thus driven by supply shocks. Food prices are rising largely due to crop failures resulting from extreme weather patterns. We’ve seen severe droughts in Russia, China, and Argentina, and severe flooding in places like Canada and Pakistan. The net result is that global grain stocks are at their lowest levels in years and this is driving food prices up. The recent spike in oil prices, on the other hand, has been driven by unrest in the Middle East and fears that global oil shipments will be disrupted. Oil exports haven’t been significantly impacted yet, but the expectation that they could be has been enough to send prices higher. Since supply-shock inflation is driven by things like weather patterns and global unrest, it is not something the Federal Reserve (or any governmental agency, for that matter) can control. Therefore, the misguided ramblings of a few notwithstanding, all the Fed can do in response is attempt to minimize the

economic impact. They do this by keeping interest rates low in order to stimulate economic growth.

The Federal Reserve: Controls Demand

The type of inflation that the Fed can control is core inflation, which is also called demand-driven inflation because it is driven by the economic demand for goods and services. If core inflation is too high, the Fed will generally raise interest rates in order to slow the economy down, thereby reducing the demand-driven inflationary pressures. Conversely, if inflation is below the Fed's target levels, they will generally lower interest rates in order to stimulate economic growth and the demand for goods and services. Core inflation is not a concern at this point because the economy, while growing, is still in recovery phase and in no danger of overheating. However, as the economic recovery continues, we will eventually reach a point where the Fed becomes concerned about core inflation. At that point, they will begin to raise interest rates and tighten the money supply.

We hope this clarification helps you when you analyze inflation, Ben Bernanke and the role of the Federal Reserve. Over the last two years, there has been a great deal of misinformation spread about the Fed, without much concern for the actual facts. When one examines the Fed's role in this recovery, it hard to find a major fault, particularly given the complexity in today's financial markets and the fact that they are trying to predict an unpredictable future.

Warren Buffett on the Economy

In our upcoming newsletter, we'll cover a lot more than just inflation. In fact, we'll re-examine our countries debt; we'll discuss security "pricing" and we'll provide an honest look at the global and domestic economy. For now, we think it's important to recognize that the economy is doing just fine. Obviously, we're not setting any records for growth. However, two years ago we explained why this recovery was going to be a long drawn-out process, with plenty of ups and downs along the way. We also stressed the resiliency of America's corporations and our ability to recover when times get tough. On Wednesday, February 2nd, Warren Buffet echoed these same themes on CNBC. Rather than take our word for it, we

thought you might like to see what Warren had to say. What follows is a brief and very frank excerpt from that interview. We hope you enjoy it.

"...I've been optimistic on America right along, as you know. I mean, I was optimistic when I knew things were going to go to hell. But things do—America gets off the track from time to time, and it was particularly so in the fall of 2008. But you can't stop this country. I mean, we have gone through, I don't know, 15 recessions, you know, world wars, civil war, you name it. And there is a resiliency to the American system. It does work. And it sputters from time to time. It'll sputter from time to time in the future, but you don't want to get too concerned about that. It's kind of like having a bad crop in farming. If you've got some good land here in the Midwest, you're going to have a bad crop occasionally. But you know you're going to have mostly good crops and we have great soil for this country, metaphorically. And it works over time."

Transcripts and video of the entire 3-hour interview are available on the CNBC website. If you didn't see the interview live, we encourage you to watch at least parts of it online. You will not be sorry...as he provides some much needed perspective on long term investing.

In closing

As always, we appreciate the opportunity to work together and your continued confidence in our firm. And, as usual, if you have any questions about this update, our newsletter, your accounts or our managers, please feel free to call or e-mail us at anytime. The recent referrals are much appreciated and, as always, we remain 100% committed to your financial well-being.

- Joe and The Gang at KWAG

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