030510 Time to go fishing?
By Gary Case

One of my favorite economic writers is Bob Andres. In his February 9, 2010 update, he made three points that I believe are worth repeating:

- We need to assess (investment) risk from an opportunity perspective. Ask yourself what the upside is in relationship to the downside. If the odds are close to even, go fishing
- Disruptions within financial system opened the door to political intrusion making the investment process more complex
- The concept of "you win by not losing" remains my preferred strategy during this uncertain period. Capital preservation and moderate growth will win the day!

He also mentioned in passing the 50% of all economists graduated in the bottom half of their class!

When we consider the risks we must manage in our investment portfolio positions, current economic, market and political factors must be considered. Bob tells us to "go fishing," or stay on the sidelines if we cannot see sufficient upside potential to substantially offset downside risk to our money.

I would like to consider interest rates and inflation as topics to address in this column. The consensus is that higher interest rates are coming. In fact, the Federal Reserve increased the discount rate in mid-February, a clear warning that near-zero interest rates won't last forever. It could be argued that the tightening cycle has begun, which means whole new strategy may be necessary to address the implications of this new Fed policy.

In the past year, prices have surged on assets that are perceived to be hedges against inflation; however, and Fed's recent action has damped inflation expectations. As interest rates move higher, expectations for higher inflation will be further muted. Try not to overweight your exposure to inflation hedges, including gold, Treasury Inflation Protected Securities, and commodities.

Rising (and higher) interest rates typically ravage the value of fixed-income assets like bonds. Recently short term interest rates have risen, "flattening" the yield cure. This means that short term interest rates are now higher relative to longer term rates. This may signal that it's time to consider shorter term fixed income investments.

Finally, higher U.S. Interest rates usually mean a stronger dollar, which in turn means portfolio earnings from non-dollar investments will be reduced by the increasing value of the dollar. Consider how robust you feel foreign earnings will be versus U.S. earnings when determining how much to invest outside of the USA.

Low-interest-rate, high-liquidity, high-inflation strategies that worked well last year may well have run their course. Traditional growth assets like stocks, as well as low-risk money funds, certificates of deposit will begin to rise, benefiting income investors.

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