

505 South Third St.
Suite 300
Louisville, KY 40202
(502) 589-1772
www.lifetimesolution.com



Capital Blueprints for the Future

Volume 14 Number 1
First Quarter 2006

Spotlight: Inflation

Fed policy will hinge on the price trend in 2006.

(1) Based on changes in the Consumer Price Index for All Urban Consumers (CPI-U), seasonally adjusted, for 12 months ending Feb. 2006. Headline inflation includes all categories. Core inflation excludes energy and food—the categories providing the most short-term volatility of late. Inflation's long-term average is 3%. (Source: Bureau of Labor Statistics, 22 March 2006)

(2) For the previous 10 quarters, growth in any quarter has never been less than 3.3% annualized. The long-term annual growth rate is in the 3.25% range. ("The Real Inflation Rate Isn't Energy", Business Week Online, 28 Nov. 2005)

(3) Here's one example: Some bond experts claim that the flat yield curve indicates that the cost of money in both the U.S. and global markets has fallen in recent years. If so, the current fed funds rate of 4.5% may carry the equivalent punch of a 6.5% rate in past cycles. (Bill Gross, "Secrets", PIMCO Investment Outlook, Dec. 2005)

(4) "Why the First Quarter Could Be A Corker", Business Week, 13 Feb. 2006, p27.

(5) In 2005, the energy portion of the CPI rose 17.1% and accounted for about 40% of the overall advance in headline inflation. Other forces, such as global competition, low wage growth, and unit cost containment by businesses are keeping rising energy costs in check. (Source: Bureau of Labor Statistics)

WITH SHORT-TERM INTEREST RATES now at 4.75%, many rate watchers assume the Federal Reserve's monetary tightening cycle is nearing an end.

The Fed has telegraphed this view at past meetings and the flat yield curve has long-anticipated it. Consumers are hoping for lower interest rates. And the equity and bond markets would rejoice in rate decreases, although for different reasons.

But the Fed's interest rate decisions will ultimately follow the inflation trend. Despite rising energy prices, a continuing strong economy and occasional monthly CPI spikes, inflation has stayed moderate by historical standards. Headline inflation measured 3.6% and core inflation 2.1% in February.⁽¹⁾

Reading the economy

Some economists believe growth has begun to cool off. The most noteworthy evidence is the drop in real GDP growth to 1.1% annualized in Q4 of last year—down sharply from the 4.1% rate in Q3 and 4.1% averaged over the prior 10 quarters.⁽²⁾ Brief monthly blips in consumer confidence, home sales, retail sales and business spending may, in hindsight, prove to be early predictors.

One quarter does not make a trend. But if the economy is slowing down and the Fed keeps raising interest rates, the excessive monetary squeeze could bring a recession. This risk of overshooting may be compounded by changing monetary fundamentals

and the Fed's shifting leadership style under new chairman Bernanke's regime.⁽³⁾

The more likely economic scenario is resurgent growth, with many Q4 indicators and economic forecasts pointing to a strong expansion in 2006. The signs included rebounding consumer confi-

dence and robust spending, rising factory orders, major jumps in spending for capital goods, software and equipment, and a rebound in business investment. Some economists expect Q4 GDP to be revised upward and project Q1 GDP growth to approach 5% annualized.⁽⁴⁾

A strong showing throughout 2006 could

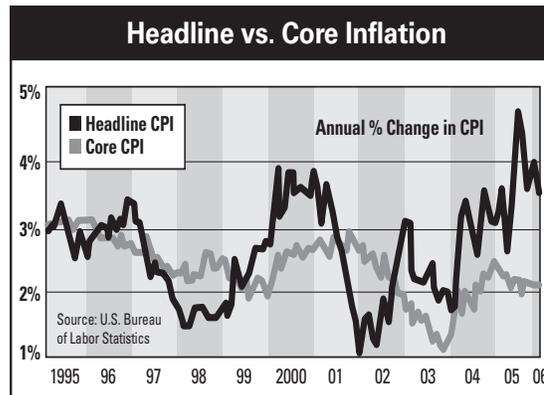
force the Fed to keep money and credit tight—or worse, to resume rate hikes after taking a neutral stance in response to moderate inflation. Whatever the economy's direction, the Fed must find the right monetary approach to avoid the extremes of overheated inflation and recession.

Other components may offer useful hints of inflation's direction during the year. These include:

- **Energy prices.** Rising energy costs have yet to drive up producer and finished good prices.⁽⁵⁾ However, the tight crude oil market remains vulnerable to supply disruptions and swelling demand from growth in China, India and Europe. More price volatility could spill over into the broad economy.

- **Consumer demand.** Consumer spending has provided a key stimulant to economic growth in recent years. But with U.S. household debt now at

Continued on back



SMART GOALS

SOMETIMES "SMART" MAY NOT EQUAL "WISE"



NOTABLE QUOTES

"Both 'what' and 'how' we spend dramatically impacts the quality of our lives, the quality of our relationships, and the legacy we leave to our children—not only in terms of dollars and cents, but also in terms of character, financial intelligence, and the ability to interact in positive ways around money matters."

A. Roger Merrill &
Rebecca Merrill
Life Matters

"Money Maturity does include skills, such as understanding investment options and using a budget effectively, but it goes much deeper—to the feelings, the heart, and yes, the soul. Money Maturity helps resolve the troubling emotional conflicts around money that never seem to go away."

George Kinder
[The Seven Stages of Money Maturity](#)

MANY OF US have been taught about setting goals through the use of the SMART acronym. The theory is that in order to be successful in our pursuits, our goals must be:

Specific
Measurable
Attainable
Realistic
Tangible

But for many, this template for goal setting is rigid and uninspiring. It puts the concept of planning and achievement in a linear framework that appeals only to the rational side of our brains. Our goals then become a list of "shoulds" that require us to be disciplined and methodical in order to reach our objectives.

As an alternative, substitute words for the SMART acronym that speak to you on an emotional level. Here is an example:

Significant
Meaningful
Attracting
Rewarding
Timely

Using this framework is more likely to result in a planning process that is successful and satisfying.

- **Significant**—Goals that resonate with what is most important to you will keep you motivated and bring joy to your journey as you move toward your objectives.
- **Meaningful**—Oftentimes individuals set goals based on what others—parents, employers, teachers, society—view as important.

However, to be truly inspiring and satisfying, your goals must align with your own values and priorities. Only then will your goals be "full of meaning" for you!

- **Attracting**—When your goals are both significant and meaningful to you, they will create a positive image that will draw you toward that which you want to experience and achieve. You won't have to rely on pure grit and determination to achieve your goals, but rather the clear vision of what you want in your life will focus your intention and guide your decisions on a day to day basis.

- **Rewarding**—Sometimes we don't make progress toward our goals because, consciously or subconsciously, we are still weighing the costs and benefits of making this commitment. An honest appraisal of this inner conflict can bring clarity to the goal setting process. We are more likely to move toward goals that

bring us a clear sense of reward along the journey as well as in reaching the destination.

- **Timely**—Do you have the time required to commit to a specific goal? In embarking on this journey, is the timing right for you? In considering these questions, it is important to realize that some goals should have specific target dates and others should not.

By imposing deadlines, we can create stress that stifles our ability to overcome obstacles in creative ways. In addition, deadlines tend to cause us to set goals that are within our current reality.

More open-ended goals encourage us to "dream big"—to stretch our imaginations and indulge in possibility thinking. ■



U.S. Economy Fights Bad News To Boost Market in 2005

DESPITE A RETREAT in the closing hours of 2005, the U.S. financial markets shook off the uncertainty of war, record-high oil prices and storm destruction to deliver modest gains. Perceived economic momentum, moderate inflation and cautious Fed helped keep all but one market indices in positive territory for the year.

The Dow Jones Industrial Average gained 1.40% for the quarter, but lost 0.61% for 2005—its first negative calendar year since 2002.

In the same period, the S&P 500 Index rose 1.58% in Q4 and 3% for the year; the Russell 2000 Index (small company stocks) edged up 0.81% in the quarter and climbed 3.32% for the year; the Nasdaq Composite Index gained 2.49% in the quarter and 1.37% for the year; and the Dow Jones Wilshire 5000 Composite Index gained 1.85% in Q4 and 4.56% for 2005. The Lehman Aggregate Bond Index returned 0.59% for the quarter and 2.43% for the year.*

The overseas markets outperformed the U.S., offering higher rewards for globally diversified investors. In 2005, the MSCI EAFE Index returned 14.02%; the Nikkei Stock Average (Japanese large company) 40.2%; the MSCI EAFE Emerging Markets Index 34.54%; and the Lehman Global Bond Index 4.38%.*

Significant economic news included the following:

- High oil prices, climbing interest rates, weaker consumer spending and lower business investment pulled down GDP growth to a 1.1% annual rate during Q4. This is well below the 4.1% annualized rate of the prior 10 quarters.

- Consumer prices climbed to 3.5% annualized through November. But core inflation (excluding food and energy) logged an estimated 2.1% annualized.

- Crude oil and gasoline prices retreated moderately in Q4 as supply and refining capacity rebounded from the storms. Oil prices climbed about 40% during 2005, which contributed heavily to the spike in overall inflation.

- The Federal Reserve increased its target fed funds rate to 4.25%, but opined that core inflation appeared moderate and the tightening phase was nearing its end.

- The yield curve continued to flatten and briefly inverted at year end. The spread between the two-year and 10-year Treasury stood at 0.20 points.

- The economy added 2.02 million jobs in 2005, for a monthly average of 168,000. This is below the 2.19 million jobs added in 2004. But economists claim that job displacement from the hurricanes accounted for the slowing trend.

- Consumer sentiment rebounded from a two-year low in October. The Conference Board's Consumer Confidence Index rose to 98.3 in November and to 103.6 in December. According to the National Retail Federation, retail sales rose an estimated 6.1% in 2005.

Looking Ahead

Despite weak Q4 growth, economists expect GDP in the 3.4% range during 2006. Keep watch on these factors:

- **Inflation and the Fed:** If core inflation exceeds the Fed's normally accepted 1%-2% range, the central bank may have to boost short-term rates beyond the 5% range expected by forecasters. Strong productivity and rising global competition could serve as counterweights to inflationary pressure.

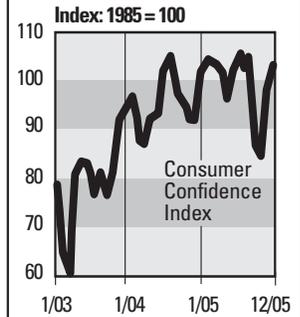
- **Housing:** Rising rates could cool off the housing market and ultimately lead to a consumer spending slowdown. Mortgage rates above 8% might constrict new borrowing.

- **Business spending:** In recent quarters, U.S. companies have held on to cash and delayed upgrades in technology and equipment. At some point, higher demand is expected to squeeze inventories and capacity, which could force businesses to boost capital investment.

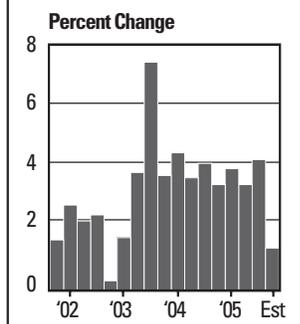
- **Global growth and exports:** Revitalized consumer demand in Europe and Japan could force central banks to raise interest rates. More attractive rates overseas could pull foreign investment away from U.S. markets. If the dollar resumes its decline in 2006, stronger foreign demand could raise U.S. export activity to its best level since the late 1990s.

- **Wages:** Rising labor productivity in the past few years has kept wage growth contained. Wages may rise if the labor market tightens in 2006 and productivity growth eases. This could raise costs and intensify inflationary pressures. ■

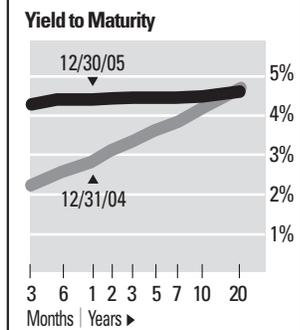
CONSUMER CONFIDENCE



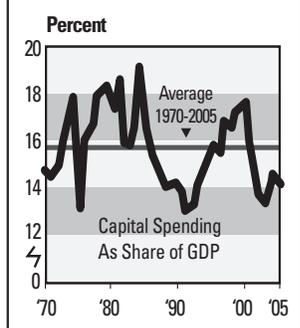
REAL ANNUAL GDP



TREASURY YIELD CURVE



BUSINESS SPENDING



The data and illustrations featured above do not offer a comprehensive review of recent economic and market performance.

* You cannot invest directly in any market index. Past performance does not guarantee future results. **This summary offers an overview of the economy and market environment at a specific point in time and is subject to change. It is not offered as investment advice or intended to predict or depict performance of any investment or portfolio.

Spotlight: Inflation

(Continued)

twice the level of 10 years ago (\$11 trillion), consumers may be running out of buying power. (A major downturn in the housing market could start the process.) Falling consumer demand could help ease inflationary pressures.

• **Supply trends.** Inflation heats up when producers of goods and services cannot keep pace with brisk demand (ie, too much money chasing too few goods). In 2005, inventories dropped as businesses struggled to fill orders with new manufacturing. Falling inventories, order backlogs, material shortages and rising utilization rates could force businesses to raise prices along the supply chain.

• **Employment, wages and productivity.** Since early 2004, rising competition for workers has steadily driven up wages. Unemployment recently fell to 4.7%—the lowest level since July 2001. So, company expansion and new hiring may further intensify competition for workers and push up wages.

Pay gains that are not offset by advancing productivity will drive up unit labor costs and feed inflation. After several years of strong productivity growth, the trend has slowed, due mostly to falling levels of capital spending.⁽⁶⁾ Sluggish productivity gains in 2006 could prove inflationary.

• **Business spending.** Many expect U.S. companies to initiate a capital spending boom in 2006.⁽⁷⁾ If so, higher spending could replace weakening consumer demand as fuel for expansion. Over time, a flood of new business investment would counter rising prices by improving supply trends and boosting labor productivity. ■

(6) U.S. labor productivity growth has averaged 3.4% since 2002. But in 2005, the rate slowed to only 2.7%. Unit labor costs rose 2.4%—the most since 2000. ("Can Productivity Keep Up the Good Work?", Business Week, 19 Dec. 2005, p25)

(7) Corporate finances are strong due to rising profits and curtailed spending in recent quarters. So, higher borrowing costs should not impede expansion of plant/facilities and investment in new equipment and technologies. Equally telling is the renewed optimism among corporate executives. ("Business Gets Behind the Wheel", Business Week, 26 Dec. 2005, p29)

In My Opinion . . .

Robert J. Cole, Jr., CLU, ChFC, CFP®

Good Grief

Lately it seems that I am becoming more acquainted with the delicate nature of life. Over the past year, we have had a number of deaths and serious illnesses occur among our clients and friends. In many cases, these involved people we have known for quite some time. The shock of a sudden loss or the stress of a slow illness both carry a special kind of grief.

The first stage is one of disbelief. We read or hear about these situations every day, but mostly they are abstract stories about faceless strangers. When the role is filled by someone close (including yourself), then the emotions hit you right between the eyes. For some strange reason we all kid ourselves into thinking that we have a right to future health and vigor—and that it will always be as good as it was.

Once we get over the initial shock, the rational part of our brain sends the message, "Yes, it is true that no one gets out of life alive". It is at this stage that we either experience satisfaction or regret. I think we spend most of our lives preparing (or not preparing) for this instant. It is very obvious that you cannot make up for a squandered life in a short period. Sometimes this grief gives way to a period of recovery, and over time one can make amends and start preparation for the next "moment of truth" which is guaranteed to come. Many times there is no second chance.

Living a purposeful life requires a great deal of effort. There are many distractions. The siren song of passive activities (such as television) promises easy fulfillment. But real life requires enjoyment *and* pain. One must constantly react to the curves that life seems to add to the straight road that we imagine to be our future. Once we pull ourselves out of the muddy underbrush of the unexpected detour, we can either stand in self pity or keep moving to the next stop. It is in this final stage where we find the advantage of going through grief. Realizing that we are the only ones in control of our response can be one of the most liberating experiences of life.

As I have said many times, the greatest wealth we have in life is the legacy we leave behind. If it is only money, the heirs normally plow through it blindly pursuing happiness in material things. If the legacy is supported by a foundation of values and contributions, the chances are much better that you will be able to face your "moment of truth" with the serenity of knowing that you did not squander the precious time you had.

This month we will be holding a workshop on "How to Write Your Ethical Will". This ancient device serves as a "gut check" on how you are doing in this area. I invite you to join us. For more information on the workshop, please visit our website at www.lifetimesolution.com.

Until next time, that's my opinion.

Robert J. Cole, Jr., CLU, ChFC, CFP®
President