

## BI-FLATION

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One of our research sources recently started using a new word "bi-flation". We have seen several research sources speaking to its concept; but the word "bi-flation" is new. "Bi-flation" means some prices can inflate (move to higher prices, like commodities), while the price of other items are biased downward (like wages and home prices). In essence, the bi-flation experience is a misallocation of capital (money) in the global economy. In actuality, inflation is occurring within developing country economies where they are aggressively consuming commodities and raw materials. Those prices are rising rapidly as products are rigorously manufactured with cheap labor rates; meanwhile items these economies don't need experience falling prices (due to declining demand; industrial developed country wage rates are falling and unemployment is high; or home prices fall which are primarily purchased by a domestic population).

The Federal Reserve is focused on creating a growth trend (to the economy) that is above the inflation rate. Inflation in the US is currently very, very low, and GDP growth is considered too low. Thus, the Fed's QE2 (quantitative easing) efforts are designed to put new money into the financial system to jump start the sluggish growth of the economy and hopefully encourage businesses to hire the unemployed. This process entails the Fed purchasing \$600 billion of Treasury securities (putting dollars into the system) over the next 8 months. Whenever new money is put into the financial and economic system, it has implications. Lots of new money drives down (depreciates) the value of the US dollar relative to other foreign currency (making our exports cheaper and easier to sell in foreign markets), while pushing up the value of stocks, bonds and commodities. Commodities are largely traded (denominated) in US dollars, so as the US dollar depreciates (more dollars are in circulation), commodity prices rise. This can create inflation down the road. Bi-flation then, is the inflation of commodity prices while experiencing deflation in low/no demand areas (houses, US employee wages).

October was another good performance month for stocks and most bonds. The financial markets continued their rally (inflating) in anticipation of Fed QE2 details being announced following the November 2 elections. QE2 was first mentioned in August, and its idea has largely resulted in the desired effect during the 2 months prior to its actual implementation; in other words, the plan is pretty fully priced in to the markets and having its desired effect. To that result, client portfolios recorded another increase in value in October, and boosted returns for the year-to-date (YTD). That's despite many, many items for worry.

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Style	October	YTD
Large Growth	+4.7%	+7.9%
Small Growth	+4.4%	+14.3%
Mid Growth	+3.9%	+14.5%
Small Value	+3.9%	+12.8%
Foreign	+3.9%	+7.1%
S&P 500	+3.8%	+7.7%
Mid Value	+3.6%	+12.2%
Large Value	+3.2%	+5.4%

Client Objectives (Stocks/Bonds)	October	YTD
20/80	+1.3%	+6.3%
35/65	+1.5%	+6.8%
50/50	+2.0%	+7.7%
65/35	+2.6%	+9.0%
80/20	+2.5%	+8.0%
95/5	+2.8%	+8.1%
S&P 500	+3.8%	+7.7%

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## BI-FLATION -CONTINUED-

Our client portfolios are conservatively invested in historically strong performing no-load mutual funds. The funds focus on high quality stocks and bonds of domestic and foreign issuers. It appears this tactical structure is generating market-similar rewards. We expect this strategy to provide better-than-index performance as the bull market continues. We also expect long-term investors, our client portfolios, to be duly rewarded for their commitment, as most investors are avoiding stocks in favor of perceived safety in bonds. When they return to stocks, they will have missed much of the return due to their late arrival.

Investors are chasing yield. They desire lower risk (less volatility) because unemployment is still high and housing prices are still uncertain; and probably also due to baby boomers standing at the doorsteps of retirement. Many investors continue to shift money from no-yielding money market funds, out of stock funds, and into bonds. We have written on this topic several times this year. It's the "rearview mirror" investment strategy – invest in what performed well in the past. We know stocks suffered two bear market declines of 50% during the last 10 years, while bonds generated positive returns. It seems anything with perceived safety, including low yielding bonds, CD's, and even annuities (with their "insurance company" label) are perceived superior to stocks. Many stocks provide dividends (yields) greater than their own 10-year corporate bonds. AND, dividends grow over the years unlike interest on bonds. WOW! Amazing! Why own very expensive bonds (low yields = high prices) when the alternative, stocks, offer higher dividend yields that grow over time? Don't take this comment wrong; bonds do offer diversification benefits; and they need to be utilized carefully at this time, given their price/yield.

One last thought. When the Fed announced plans for QE2 on Wednesday (November 3), the world financial markets rallied (inflated) strongly. This action seems to us, a short-term buyers panic – buying on news that has already been factored into the market since August 24 when the Fed first hinted at the idea. In the short, near-term, we expect this panic buying (to avoid being left behind) to evaporate. BUT, we do expect the stock market to continue its bull-track and provide rewarding returns as the year concludes. Why? The economy is slowly growing; the world economy is growing; and stocks offer more attractive return opportunities than bonds, annuities or money market funds. We continue to monitor the economic (financial and political) landscape, as the "bill is coming due." We cannot keep "kicking the can down the street." We are concerned that the Fed is attempting to be the "repair shop" for broken fiscal, trade, and/or regulatory policy. Monetary policies could be poor substitutes for responsible government policy. We are bullish until the "bill comes due".

### ANNOUNCEMENTS:

Nvest Wealth Strategies is hosting a **Talk Strategy meeting on Thursday, November 11 at Wedgewood Golf & C.C.** from 7:00 to 8:00pm. We invite you and/or friends to enjoy dessert and participate in a discussion on the current market environment and outlook for 2011. Additionally, guest speaker Clayton Rose, CPA will present on "Uncle Sam's Ever Changing Appetite: Year-End Tax Ideas & Future Tax Outlook"; he will also be reviewing Roth IRA conversions. Please RSVP if you plan on attending.



**WILDLIGHTS AT THE COLUMBUS ZOO:** Nvest will be hosting its annual client appreciation night on Thursday, December 9 from 5:30 - 9:00pm at the Columbus Zoo. There will be seasonal refreshments in the Education Building. If you and your family can attend, please send an email to [steve@nvestwealth.com](mailto:steve@nvestwealth.com) to reserve your complimentary passes for admission and parking. Further details will be provided soon!

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